FDIC Banking Review

Interstate Banking The Past, Present And Future
by David Holland, Don Inscoe, Ross Waldrop and William Kuta

The nation's press has been rife with announcements of merger and acquisition plans by large banking organizations since midyear 1995. This burst of announcements is part of a long-term fundamental restructuring of the industry that began in the early 1980s and is likely to continue for the foreseeable future. An integral component of this restructuring is the rise of interstate or multi-state banking, and particularly an increase in the number and economic importance of banking organizations with banking offices in more than one state.

The restructuring of the banking industry may be decomposed into three interrelated trends. First, interstate banking has moved from being an oddity to being a prominent characteristic of the industry. At midyear 1995, two-thirds of the nation's banking assets were held by multi-state banking organizations. Second, consolidation, due mostly to mergers and acquisitions but also to bank failures and to a paucity of new entrants, has reduced the numbers of banking and thrift institutions substantially. For example, between year-end 1984 and March 31, 1996, the number of banking organizations bank holding companies and independent banks and thrifts declined 36 percent, from 14,887 to 9,481. Third, by some measures, the banking industry has become more concentrated. At year-end 1984, the largest 42 banking organizations held 25 percent of domestic deposits. At the end of the first quarter of 1996, the largest 13 banking organizations held 25 percent of domestic deposits. Moreover, five percent of the nation's banking organizations held 75 percent of domestic deposits.

In 1994, Congress, with the enactment of the Riegle-Neal Interstate Banking and Branching Efficiency Act, added impetus to the ongoing trends. The major effect of this law derives from its authorization of interstate branching. Given the consolidation that has previously occurred in states where branching laws were already liberalized, banking organizations are expected to make extensive use of this authorization.

This study documents the changes in the geographic scope, structure and concentration of the U.S. banking and thrift industries that have occurred over the past decade. Prospects for the continuation of these trends are analyzed from a variety of perspectives. Finally, the study attempts to identify the effect of increasing consolidation in banking on the Federal Deposit Insurance Corporation's supervisory activities.

The Past and Present

For most of the nation's history, state boundaries controlled and curtailed the growth of individual banking organizations. In most instances, a U.S. banking organization could not establish domestic deposit-taking offices outside of the state where its home office was located. Moreover, its ability to expand within its home state was often limited. One result of this situation was a decentralized banking industry with numerous participants and protected geographic markets.

Over the brief period of little more than a decade, however, the U.S. banking industry has undergone what could be called a structural change of seismic proportions.[1] State banking barriers have dropped quickly and significantly. At midyear 1984, 33 percent of the nation's banking assets were controlled by bank and thrift organizations with operations in two or more states. By midyear 1995, the proportion had grown to 67 percent, representing two-thirds of the nation's banking assets. A major consequence of the rise of interstate banking has been consolidation and concentration in the industry. The number of banking organizations has declined, and the proportions of banking assets and deposits controlled by larger banking organizations have risen.

The growth of interstate banking and the accompanying industry consolidation has been propelled by marketplace forces that do not recognize political borders.[2] In the decades following World War II, technological changes in communications and data processing eroded much of the common ground that banking markets and political boundaries may once have shared. Beginning in the late 1970s and early 1980s, a number of states acknowledged the changing economics of banking by allowing the creation and development of interstate bank holding companies companies that own banks in two or more states. The state laws varied considerably. Some of the states acted individually. Other states required reciprocity an out-of-state bank holding company could acquire an in-state bank only if the out-of-state holding company's home state granted similar acquisition privileges to holding companies in the target state. Still other states entered into reciprocal compacts with neighboring states. Some state laws, particularly those enacted pursuant to so-called "compacts," limited permissible out-of-state entrants to those from the neighboring geographic region.

Table 1

State Elections Under the Interstate Branching Provisions
of the Riegle-Neal Act April 30, 1996

States Opting-In Prior to June 1, 1997 (24):

Alaska	Idaho	Mississippi	North Carolina	Utah
Arizona	Indiana	Nevada	Oregon	Vermont
California	Maine	New Jersey	Pennsylvania	Virginia
Connecticut	Maryland	New Mexico	Rhode Island	Washington
Delaware	Michigan	New York	South Dakota	

States Opting-In on June 1, 1997 Trigger Date (11):

Alabama	Illinois	Oklahoma
Florida	Minnesota	Tennessee
Georgia	New Hampshire	West Virginia
Hawaii	North Dakota	

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State Opting Out:
Texas (sunsets September 2, 1999)
Source: The American Banker
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Any uncertainties regarding state initiatives to remove barriers to bank holding company expansion across state lines were eliminated in 1985. In its decision in Northeast Bancorp v. Board of Governors of the Federal Reserve System, 472 U.S. 159, the U.S. Supreme Court upheld the ability of the states to reduce selectively, under the Bank Holding Company Act, restrictions on entry by out-of-state holding companies.

In 1994, Congress in the Riegle-Neal Interstate Banking and Branching Efficiency Act ("the Riegle-Neal Act"), Pub. L. 103328, added a federal element to the states' initiatives on interstate banking. Under the Riegle-Neal Act, most remaining state barriers to bank holding company expansion were removed effective September 29, 1995. Holding company growth, however, is restrained by explicit, statutory deposit concentration limits: a ten percent nationwide limit and a 30 percent statewide limit.[3]

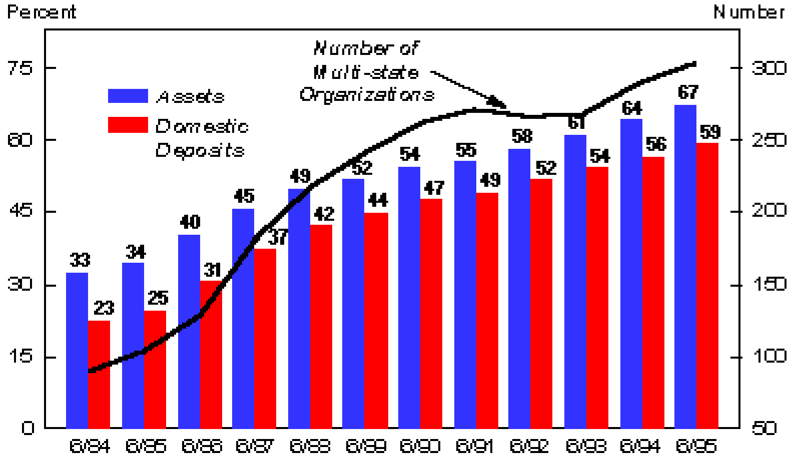
The Riegle-Neal Act also authorizes a previously unused interstate expansion alternative for banks branching.[4] Beginning June 1, 1997, banks may merge across state lines, a process that would result in the offices of one bank becoming branches of the other. Interstate branching through merger is subject to the same concentration limits as are interstate acquisitions by bank holding companies. States may elect to either prohibit or authorize interstate branching through mergers prior to June 1, 1997. States may also elect to authorize de novo interstate branching, or entry from out of state by acquisition of one or more existing branches. The status of state elections as of April 30, 1996, is summarized in Table 1.

Speculation on the impact of the Riegle-Neal Act requires an awareness of the interstate and consolidation trends that have been underway for at least the last ten years. The Riegle-Neal Act was not a precipitator of these trends. The Act, particularly its branching provisions, may shape and accelerate, the future course of these trends. To a large extent, however, the Riegle-Neal Act is merely an acknowledgment of what is being wrought by the marketplace under state laws. Consequently, the remainder of this section details the recent movements affecting the structure of the banking industry. A complete set of charts and data chronicling changes in the statistics of the banking industry is available from the authors.

The Growth of Interstate Banking

From midyear 1984 to midyear 1995, the number of multi-state banking organizations bank holding companies with banks in two or more states, and thrift institutions with offices in two or more states increased from 89 to 303 (Figure 1). When compared with the number of commercial banks and savings institutions in the nation (12,249 at midyear 1995), the number of multi-state organizations might seem small. The low number is misleading, however. Together, these multi-state organizations held 67 percent of the combined assets of the nation's commercial banks and thrifts at midyear 1995 up from 33 percent in 1984 and 59 percent of the nation's domestic deposits up from 23 percent in 1984 (Figure 1).

Figure 1
Number of Multi-state Organizations and Their Share of Bank Assets and Deposits*

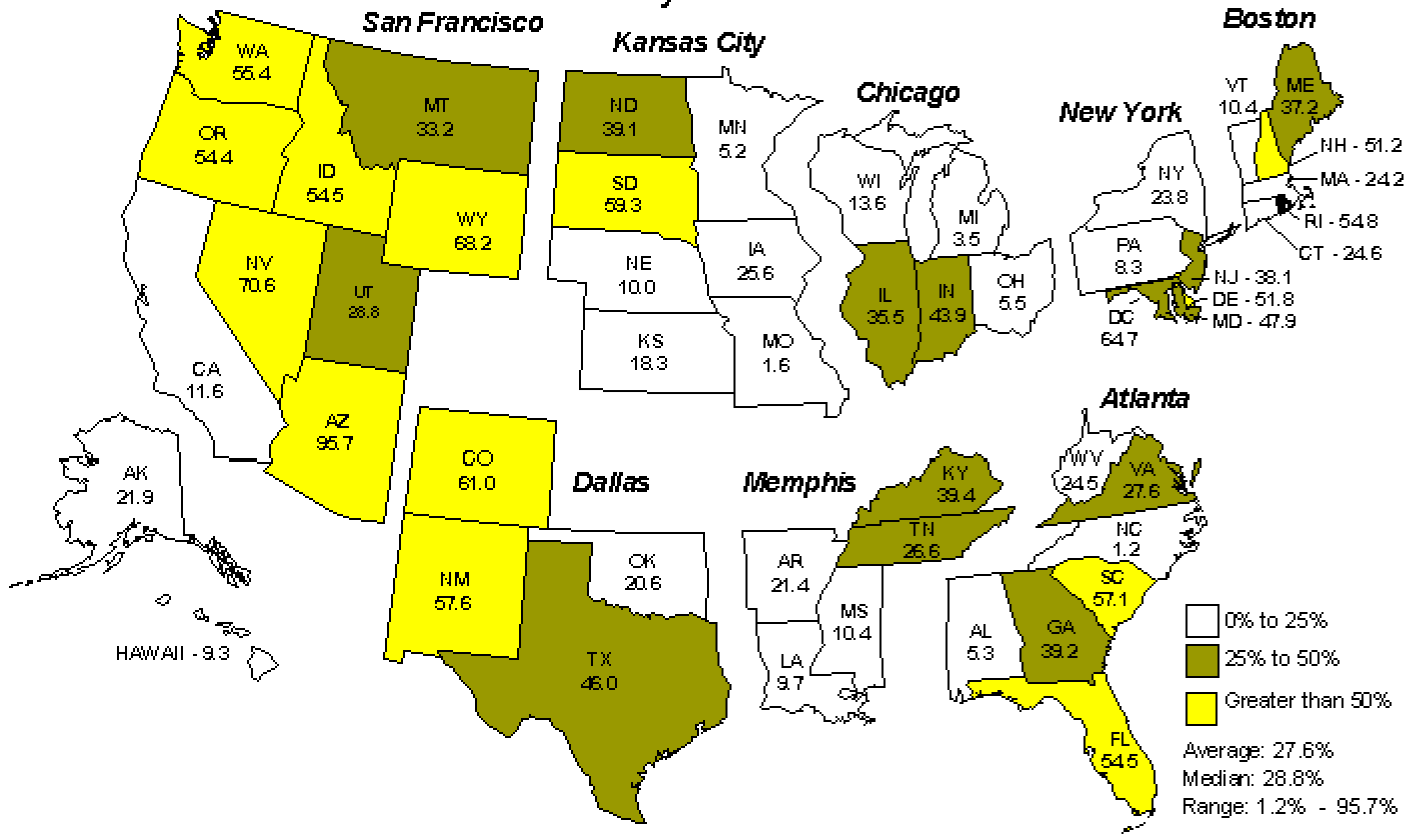


*Multi-state organizations are bank holding companies and independent depository institutions with banking operations in two or more states.
Sources: Bank Summary of Deposits, Thrift Branch Office Survey, FRB NIC Database, FDIC DRS RIS Database.

The states have embraced interstate banking with varying degrees of enthusiasm, but no state has avoided it entirely. In every state, some proportion of deposits is held in offices owned ultimately by out-of-state banking organizations. At year-end 1995, the average proportion of state deposits held by out-of-state organizations was 27.6 percent, the median was 28.8 percent, and the range stretched from 1.2 percent for North Carolina to 95.7 percent for Arizona (Figure 2). The five states, including the District of Columbia, with the largest percentages of deposits held by out-of-state organizations were: Arizona, 95.7 percent; Nevada, 70.6 percent; Wyoming, 68.2 percent; the District of Columbia, 64.7 percent; and Colorado, 61.0 percent.

Figure 2

Shares of Deposits Held by Out-of-State Organizations, by State



* States are grouped into the eight FDIC DOS supervisory regions.
Sources: Bank Summary of Deposits, Thrift Branch Office Survey, FRB NIC Database, FDIC DRS RIS Database.

It should be noted that measuring a state's involvement in the interstate banking movement by the percentage of in-state deposits controlled by out-of-state organizations can be misleading. For example, only 1.2 percent of North Carolina's deposits are in offices of out-of-state organizations. Yet because several bank holding companies headquartered in North Carolina are among the leading multi-state banking organizations and have substantial presences in other states, North Carolina could certainly not be considered a bystander in the interstate banking movement.

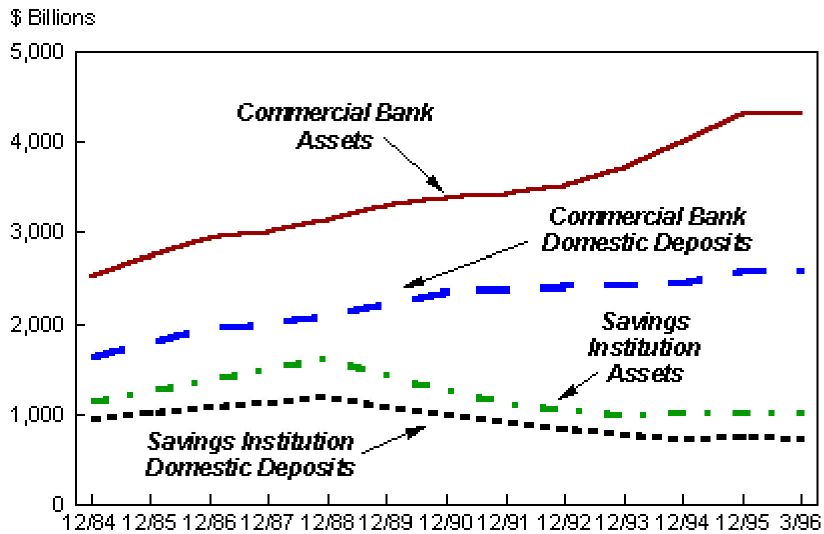
Banking Industry Consolidation

A variety of statistics show a consolidating banking industry. The consolidation has been due to a large number of exits from the industry mostly in the form of mergers and acquisitions among healthy institutions but also in the form of bank failures coupled with only a small number of entrants. From 1984 to the end of the first quarter of 1996, the number of commercial banks declined 32 percent, from 14,483 to 9,841. The number of savings institutions declined 41 percent, from

3,418 to 2,005. The number of bank holding companies declined seven percent, from 5,707 to 5,305. The number of banking organizations bank holding companies and independent banks and thrifts, perhaps the most meaningful tabulation declined 36 percent, from 14,887 to 9,481(Figure 3).

Declining numbers of institutions do not necessarily equate to a declining industry. During the same period that the numbers of institutions were declining, 1984 to the end of the first quarter of 1996, in nominal terms[5] the combined assets of commercial banks and savings institutions grew 46 percent, and domestic deposits grew 28 percent (Figure 4).

Figure 4
Assets and Deposits of Commercial Banks and Savings Institutions



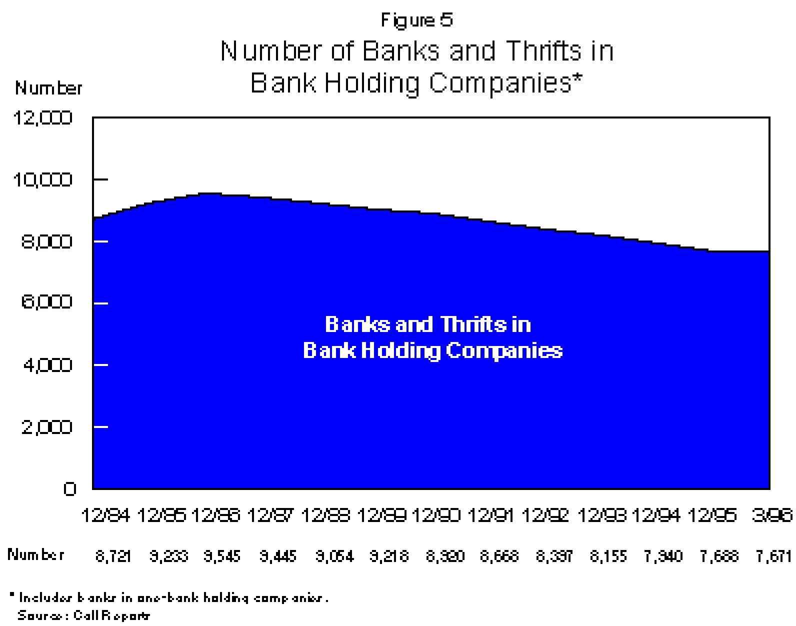
Source: FDIC DRS RIS Database

Table 2
Percentages of Assets and Deposits in Independents and Holding Companies

	12/84	12/85	12/86	12/87	12/88	12/89	12/90	12/91	12/92	12/93	12/94	12/95	3/96
Percent of Total Assets													
Holding Companies													
Multibank	46.54	49.61	51.61	51.93	51.01	53.38	55.67	57.36	58.79	61.07	64.04	66.65	66.86
One-Bank	15.52	13.47	11.83	11.57	11.93	12.56	13.83	14.91	15.40	15.27	14.31	13.27	13.22
IndependentBanks/Thrifts	37.94	36.93	36.56	36.56	37.06	34.06	30.50	27.73	25.81	23.70	21.65	20.08	19.92
Percent of Total Domestic Deposits													
Holding Companies													

Multibank	38.06	41.42	44.68	45.83	46.23	48.05	50.90	51.96	53.39	55.01	57.16	59.45	59.71
One-Bank	17.37	15.71	14.11	13.57	13.92	14.45	15.59	16.82	17.45	17.76	17.62	16.97	16.94
IndependentBanks/Thrifts	44.57	42.87	41.21	40.59	39.85	37.50	33.51	31.22	29.15	27.23	25.21	23.58	23.35

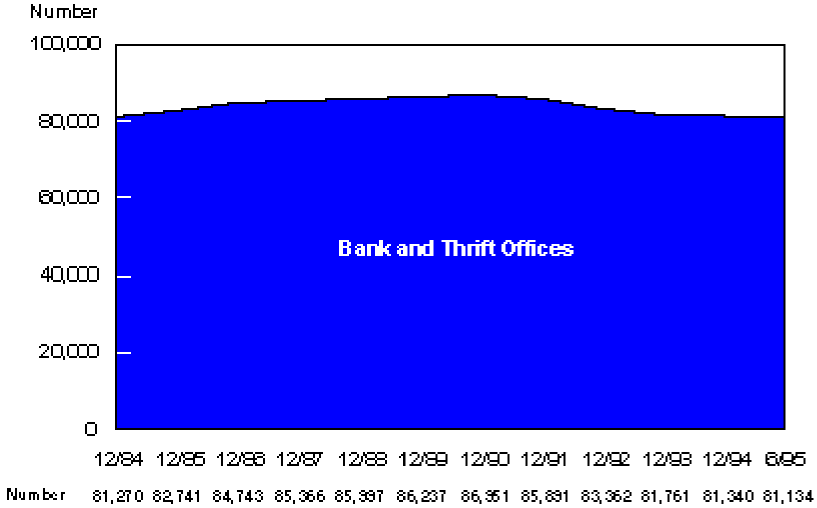
The decline in the numbers of banks and savings institutions reflects a shift toward the holding company form of organization. As can be seen in Table 2, the proportion of depository institution assets controlled by holding companies both one-bank and multibank grew from 62 percent at year-end 1984 to 80 percent as of March 31, 1996. Similarly, the proportion of domestic deposits controlled by holding companies grew from 55 percent to 77 percent. The proportion of banks and thrifts in holding company structures grew from 49 percent to 65 percent (Figure 5).



In contrast to the declining numbers of banking organizations, the number of banking offices remained fairly constant through 1990, as branch offices proliferated. The number of bank and thrift offices rose from 81,000 in 1984 to 87,000 in 1990. Subsequently, they have declined 6.7 percent, to 81,000 as of March 31, 1996 (Figure 6).

Figure 6

Number of Bank and Thrift Offices



Source: Institution Structure Database

There are three main factors responsible for the net decline of 5,931 commercial banks and thrifts during the period 1985 to 1995 (Figure 7). First, mergers and acquisitions that have not involved federal assistance have accounted for most of the consolidation among commercial banks and savings institutions over the past decade. From the end of 1985 through 1995, more than 6,000 commercial banks and savings institutions have been absorbed through unassisted mergers. Second, over the same period, more than 2,400 insolvent banks and thrifts have been closed or merged into healthy institutions with federal assistance. Third, there have been 2,554 new commercial banks and savings institutions chartered.

Banking Industry Concentration

A consolidating industry can be a concentrating industry. The number of banking organizations controlling 25 percent of domestic deposits declined from 42 at year-end 1984 to 13 at the end of the first quarter of 1996 (Figure 8). Similarly, the number controlling 50 percent of domestic deposits declined from 242 to 61, and the number controlling 75 percent of domestic deposits declined from 1,314 to 466. Another way to view the concentration of banking is to note that at the end of the first quarter of 1996, five percent of the nation's banking organizations 501 companies held 75 percent of domestic deposits.

Figure 7

New Charters, Closed Banks, and Mergers

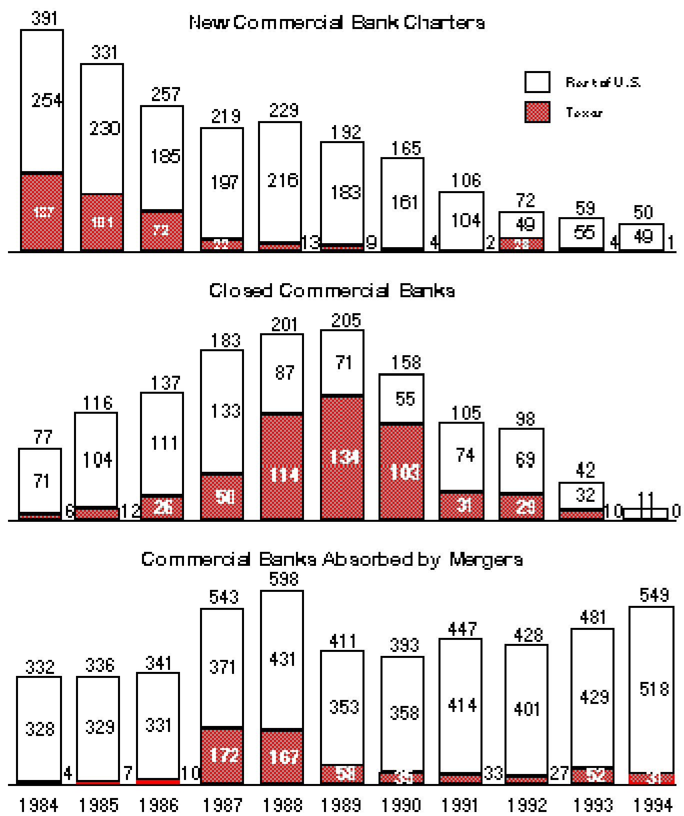
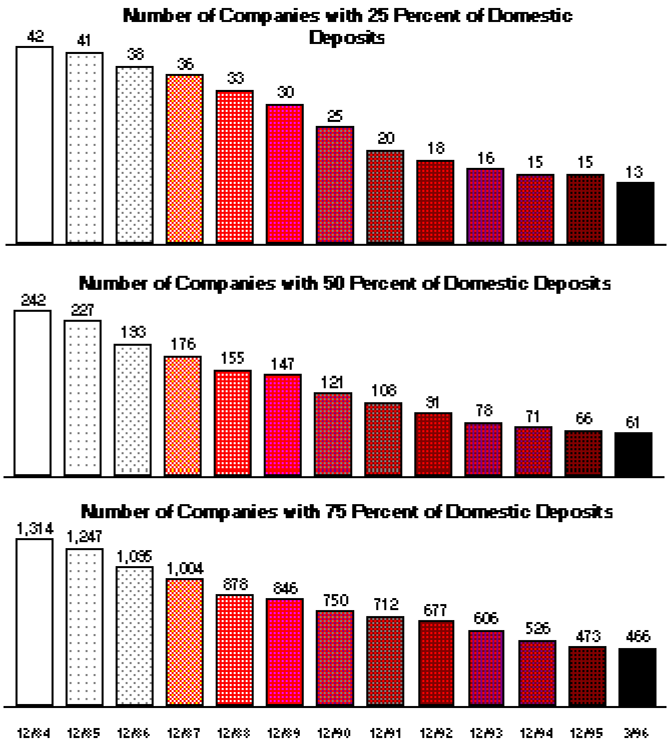


Figure 8
Concentration Trends



* Includes deposits of insured commercial banks and savings institutions. Individual companies have been accounted for at their highest level of consolidation (multibank holding companies, one-bank holding companies or independent banks/thrifts).

Source: FDIC DRS RIS Database

With increased consolidation, will antitrust problems become a major concern in banking?[6] The Riegle-Neal Act addresses this issue through state and national deposit concentration limits that reduce the likelihood of antitrust problems developing. These limits are 30 percent of a state's deposits and ten percent of the nation's deposits. With certain exceptions, an application by a banking organization for an interstate merger or acquisition cannot be approved if the effect would be to exceed one of these limits. As of the first quarter of 1996, the banking organization with the largest proportion of the nation's domestic deposits was BankAmerica Corporation, with 3.62 percent, well below the ten percent limit (Table 3). Banking organizations in six states exceeded the 30-percent state limit, and 13 other banking organizations each held more than 20 percent of a state's deposits (Table 4). Concentration limits apply only as a condition of approval for interstate merger or branching transactions and not to intrastate transactions.

Fall of Intrastate Barriers

Other legal changes that have received less notice than the lifting of interstate barriers to bank expansion are the easing of geographic barriers within states. Over the last ten years, a number of states have removed or reduced restrictions within their borders on mergers and branching by banks (Figure 9). The resultant increase in freedom to expand within these states and to adopt preferred organizational structures has been a major contributor to the industry consolidation and concentration trends. The 16 states that adopted statewide branching since 1984 have accounted for 67.9 percent of the net reduction in commercial banks and savings institutions during that time.

Table 3
Banking Organization With the Largest Percentages of National Domestic Deposits as of March 31, 1996

Banking Organization	Percent
BankAmerica Corp.	3.62
NationsBank Corp.	2.94
Chase Manhattan Corp.*	2.93
First Union Corp.	2.74
Banc One Corp.	2.12
Citicorp	1.57
Fleet Financial Group	1.49
First Interstate Bancorp.	1.47
First Chicago NBD Corp.	1.38
PNC Bancorp.	1.37

* Chemical Banking Corporation and Chase Manhattan Corporation merged April 1, 1996.

Sources: Bank Summary of Deposits, Thrift Branch Office Survey, FRB NIC Database, FDIC DRS RIS Database

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Recent Merger and Acquisition Activity

A number of mergers and acquisitions among large banking organizations were announced in 1995. The total number of transactions announced during the year was 443.[7] The amount of assets in the institutions to be acquired totaled $488 billion, far exceeding the amount of assets in acquired institutions in any previous year (Table 5). The next highest year was 1991 when the assets in acquired institutions totaled $297 billion. A variety of reasons may help to explain the unprecedented merger activity among very large banks. Through July 1996, 229 transactions have been announced with assets in institutions to be acquired totaling $164 billion. The largest transaction announced in 1996 involved the acquisition of First Interstate Bancorp by Wells Fargo and Company with seller's assets of $58 billion.

Favorable Environment. The legal environment is now more permissive. As has been discussed, the Riegle-Neal Act allows bank holding companies more freedom to acquire banks across state lines than was possible under the existing state authorizations. At the same time, there are few potential acquisitions that would be precluded by the deposit concentration limitations specified in the new law.

Table 4
States Where an Out-of-State Banking Organization Holds More Than 20 Percent of the Domestic Deposits in a State,

as of June 30, 1995

State	Banking Organization	Percent
Rhode Island	Royal Bank of Scotland	33.28
Arizona	Banc One Corp.	31.05
Nevada	First Interstate BancCorp.	25.44
Nevada	BankAmerica Corp.	25.30
Idaho	First Security Corp.	26.13
Arizona	BankAmerica CorP.	27.47
Washington	Bank America Corp.	21.95
South Dakota	Citicorp	21.26
New Mexico	Boatmen's Bancshares	21.96
Maine	KeyCorp.	20.73
North Dakota	First Bank System	20.89
Wyoming	NorWest Corp.	27.71

States Where Banking Organization Holds More Than20
Percent of the Domestic Deposits in Its Own State,
as of June 30, 1995

State	Banking Organization	Percent
Alaska	National BancCorp of Alaska	41.25
Idaho	West One BancCorp.	34.09
Rhode Island	Fleet Financial Group	33.74
Hawaii	BancCorp Hawaii	30.52
Utah	First Security Corp.	30.10
Oregon	US BancCorp.	28.85
Hawaii	First Hawaiian	27.98
District of Columbia	Riggs National Corp.	26.55
Alaska	First National Bank of Anchorage	22.23
California	BankAmerica Corp.	20.90
Minnesota	Norwest Corp.	20.69
Minnesota	First Bank System	20.37
Utah	Zions BancCorp.	20.22
Delaware	MBNA Corp.	22.21

Sources: Bank Summary of Deposits, Thrift Branch Office Survey, FRB NIC Database, FDIC DRS RIS Database

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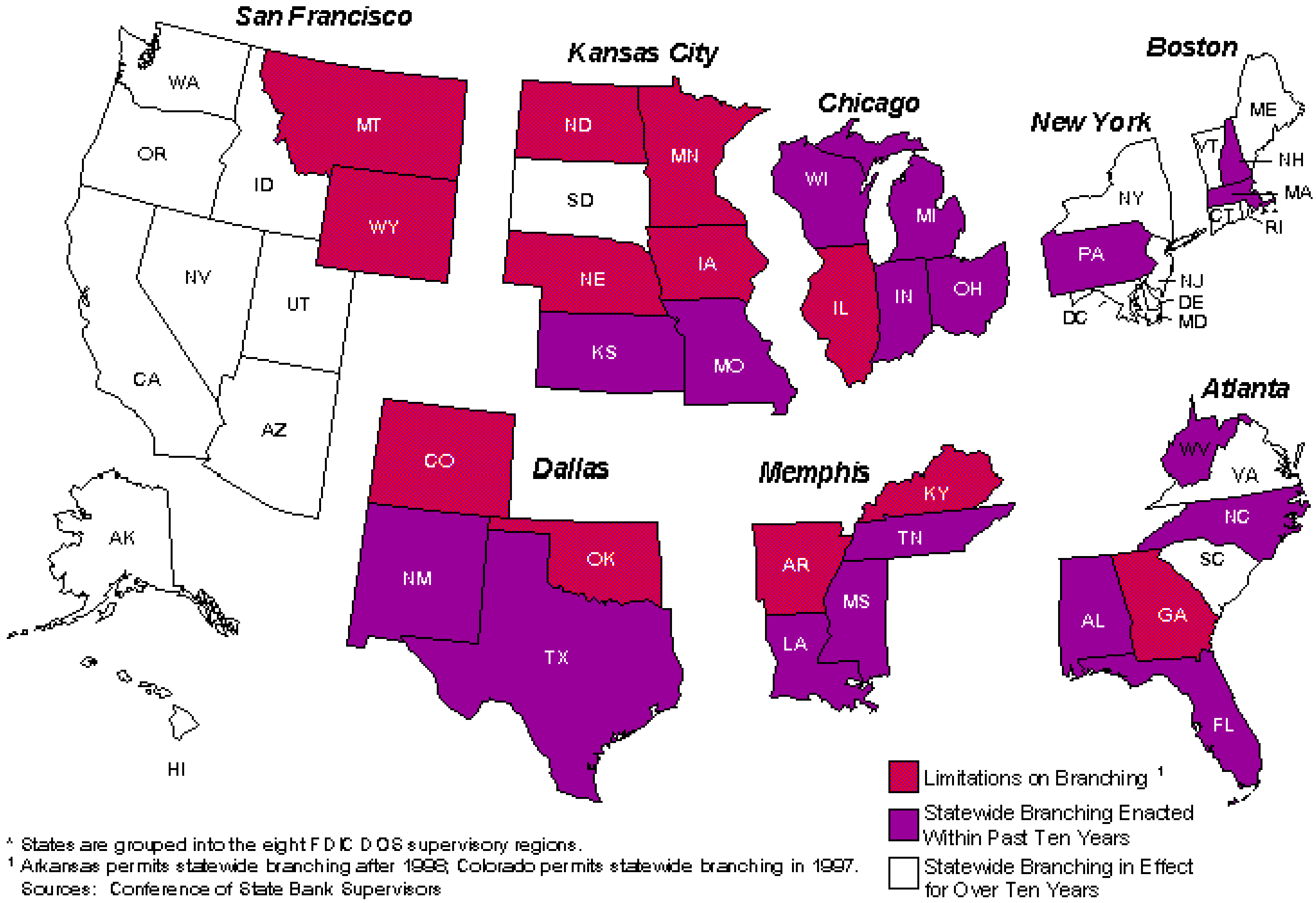
The economic climate also favors mergers and acquisitions. Low interest rates and an improved economy have combined to push bank profits to record levels. This, in turn, has boosted stock prices, giving acquirers more purchasing power. High stock prices have facilitated "poolings" in which the acquirer trades its stock for the stock of the selling company. Of the 443 transactions announced in 1995, 177 were cash-only purchases, and 255 included stock trades.[8] Also, equity capital ratios have reached their highest level in 40 years. Historically, high capital levels have provided more leveraging capability, allowing companies with excess capital to grow their assets through acquisitions.

Figure 9

State Branching Laws*



* States are grouped into the eight FDIC DOS supervisory regions.
1 Arkansas permits statewide branching after 1998; Colorado permits statewide branching in 1997.
Sources: Conference of State Bank Supervisors

Table 5
Bank and Thrift Merger and Acquisition Announcements,
1989 through August 5, 1996
(Dollar Amounts in Billions)

Announced
Mergers and Acquisitions
Completed
Mergers and
Acquisitions

Number
Percent of
Sellers'
Percent of
Value
Percent of
of
Announced
Assets of
Announced
of
Announced
Number
Sellers'
Deal
Deals
Deals
Completed
Deals
Completed
Deals

Year	Announced	Assets	Value	Completed	Completed	Deals	Assets	Deals	Value
1996	229	163.9	$23.7	35	15.28%	$69.8	42.59%	$14.0	59.07%
1995	443	488.0	63.2	373	84.20	482.6	98.89	62.4	98.81
1994	565	190.1	22.4	523	92.57	181.9	95.69	21.2	94.78
1993	477	175.4	23.5	447	93.71	169.0	96.37	22.5	95.69
1992	399	181.0	16.3	357	89.47	159.3	87.99	15.3	93.51
1991	305	296.7	22.1	274	89.84	291.3	98.21	21.7	98.41
1990	216	87.4	4.6	168	77.78	36.6	41.84	3.1	68.37
1989	201	115.2	11.5	173	86.07	103.3	89.62	10.5	91.58

*1995 Sellers' Assets and Deal Value do not include theannounced merger of First Bank, Inc. and First Interstate Bancorp. (seller assets of $55 billion and deal value of $10.7 billion). This deal was terminated. The 1996 Sellers' Assets include the Wells Fargo acquisition of First Interstate, which was completed on April 1, 1996.

Note: Run date for 1996 and 1995 data is 8/5/96. Run date for 1989 - 1994 data is 7/30/96.

Source: SNL Securities

Motivations for Sellers. Sellers have an opportunity to lock in high stock prices. Bank stock prices have risen since 1991, reflecting three consecutive years of record earnings by the commercial banking industry. Various bank-stock indexes show that prices continued to increase during 1995. Many acquisitions announced in 1995 were priced at a high premium over book value. The average price-to-book value ratio for acquisitions has increased in each of the last four years. According to data compiled by SNL Securities, the average price-to-book ratio for banks and thrifts acquired during 1995 was 169 percent.

Some banks may choose to sell to a friendly purchaser to avoid the possibility of a hostile takeover in the future. Many of the target companies have fully recovered from asset-quality problems and have clean balance sheets. Some companies may opt to sell instead of trying to expand in a slow-growth industry.

Motivations for Buyers. Some of the recent transactions involve institutions that each predominantly operate in the same market. Operating efficiencies and product synergies are cited as motivations where branch structures or product lines overlap. Acquirers in within-market transactions may be seeking to protect today's high profits through cost-cutting and increased market share.

A number of the announced transactions expand the acquirer's geographic and product markets. Inter-market transactions may be motivated by the desire to diversify sources of income and risks. Transactions may also be undertaken for defensive reasons: larger banking companies have fewer potential acquirers.

Table 6

Number of FDIC-Insured Commercial Banks and Savings Institutions, by Asset Size*

Yr./ Qtr.	Less than $100Million No.	%of Total	$100 Million to $1Billion No.	%of Total	$1Billion to $5Billion No.	%of Total	$5 Billion to $10 Billion No.	%of Total	$10 Billionor More No.	%of Total	TOTAL
96:1	7,480	63.1	3,787	32.0	406	3.4	86	0.7	87	0.7	11,846
95:4	7,568	63.2	3,820	31.9	414	3.5	78	0.7	90	0.8	11,970
95:3	7,754	64.0	3,789	31.3	395	3.3	92	0.8	82	0.7	12,112
95:2	7,930	64.7	3,759	30.7	388	3.2	92	0.8	80	0.7	12,249
94:4	8,254	65.5	3,792	30.1	389	3.1	93	0.7	74	0.6	12,602
93:4	8,837	66.8	3,827	28.9	405	3.1	87	0.7	64	0.5	13,220
92:4	9,401	67.9	3,884	28.0	426	3.1	82	0.6	59	0.4	13,852
91:4	9,982	68.9	3,921	27.1	435	3.0	86	0.6	58	0.4	14,482
90:4	10,576	69.8	3,967	26.2	470	3.1	85	0.6	60	0.4	15,158
89:4	11,177	70.8	3,973	25.2	499	3.2	88	0.6	59	0.4	15,796
88:4	11,911	71.9	3,985	24.1	511	3.1	92	0.6	62	0.4	16,561
87:4	12,676	73.1	4,025	23.2	507	2.9	71	0.4	57	0.3	17,336
86:4	13,221	74.0	4,049	22.7	484	2.7	75	0.4	47	0.3	17,876
85:4	13,631	75.6	3,836	21.3	462	2.6	68	0.4	36	0.2	18,033
84:4	13,807	77.1	3,594	20.1	409	2.3	59	0.3	32	0.2	17,901
84:1	14,034	78.5	3,399	19.0	375	2.1	50	0.3	28	0.2	17,886

Assets of FDIC-Insured Commercial Banks and Savings Institutions, by Asset Size*

Yr./ Qtr.	Less than $100 Million Assets	% of Total	$100 Million to $1 Billion Assets	% of Total	$1Billion to $5 Billion Assets	% of Total	$5 Billion to $10 Billion Assets	% of Total	$10 Billion orMore Assets	% of Total	TOTAL
96:1	$341,862	6.4	$971,161	18.2	$869,835	34.2	$596,911	11.2	$2,544,972	47.8	$5,324,741
95:4	344,564	6.5	975,148	18.3	897,196	34.9	549,033	10.3	2,572,479	48.2	5,338,420
95:3	348,932	6.6	973,733	18.5	844,973	34.5	639,911	12.2	2,446,431	46.6	5,253,980
95:2	354,785	6.8	962,844	18.6	836,752	35.0	644,157	12.4	2,389,397	46.1	5,187,935
94:4	366,345	7.3	969,139	19.3	850,211	39.3	671,097	13.4	2,162,509	43.1	5,019,301
93:4	388,472	8.3	975,725	20.7	883,409	48.2	626,293	13.3	1,833,181	38.9	4,707,080
92:4	401,966	8.9	996,429	22.0	927,719	56.9	580,012	12.8	1,629,763	35.9	4,535,889
91:4	412,705	9.1	1,008,979	22.2	964,673	62.1	604,639	13.3	1,552,646	34.2	4,543,642
90:4	423,960	9.1	1,020,390	22.0	1,034,167	66.1	605,861	13.0	1,564,271	33.7	4,648,649
89:4	436,058	9.2	1,028,182	21.8	1,093,290	71.5	639,324	13.5	1,530,020	32.4	4,726,874
88:4	457,330	9.7	1,037,334	21.9	1,096,655	71.9	620,073	13.1	1,525,893	32.2	4,737,285
87:4	477,774	10.6	1,031,801	22.9	1,073,738	74.8	483,646	10.7	1,435,100	31.9	4,502,059
86:4	490,312	11.3	1,038,162	24.0	992,492	76.9	515,354	11.9	1,291,245	29.8	4,327,565
85:4	489,922	12.3	985,035	24.7	936,800	84.5	472,688	11.8	1,108,881	27.8	3,993,326
84:4	484,170	13.3	934,770	25.6	827,910	82.5	403,091	11.0	1,003,176	27.5	3,653,117
84:1	482,454	14.3	874,915	25.9	746,222	79.5	332,415	9.9	938,115	27.8	3,374,121

*Excludes institutions operating in RTC conservatorship.
Source: FDIC Division of Research and Statistics, RIS Database

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Consummation of the Transactions. To achieve cost savings, acquirers may decide to convert newly acquired subsidiaries to branches, and to close branches where there is overlap. The transactions require approval by stockholders and regulators. Completion of an announced transaction reduces the number of independent banking organizations but may not necessarily lead, immediately or ultimately, to a reduction in the number of banks. Whether the number of commercial banks or savings institutions declines after bank holding companies combine depends on whether the holding company subsidiaries are also combined. While there has been considerable consolidation activity following the completion of mergers and acquisitions in the past, state and federal branching restrictions have limited the decline in the number of banks. The Riegle-Neal Act, however, will allow bank holding companies considerable freedom to merge banking subsidiaries across state lines and to convert acquired institutions into branches.

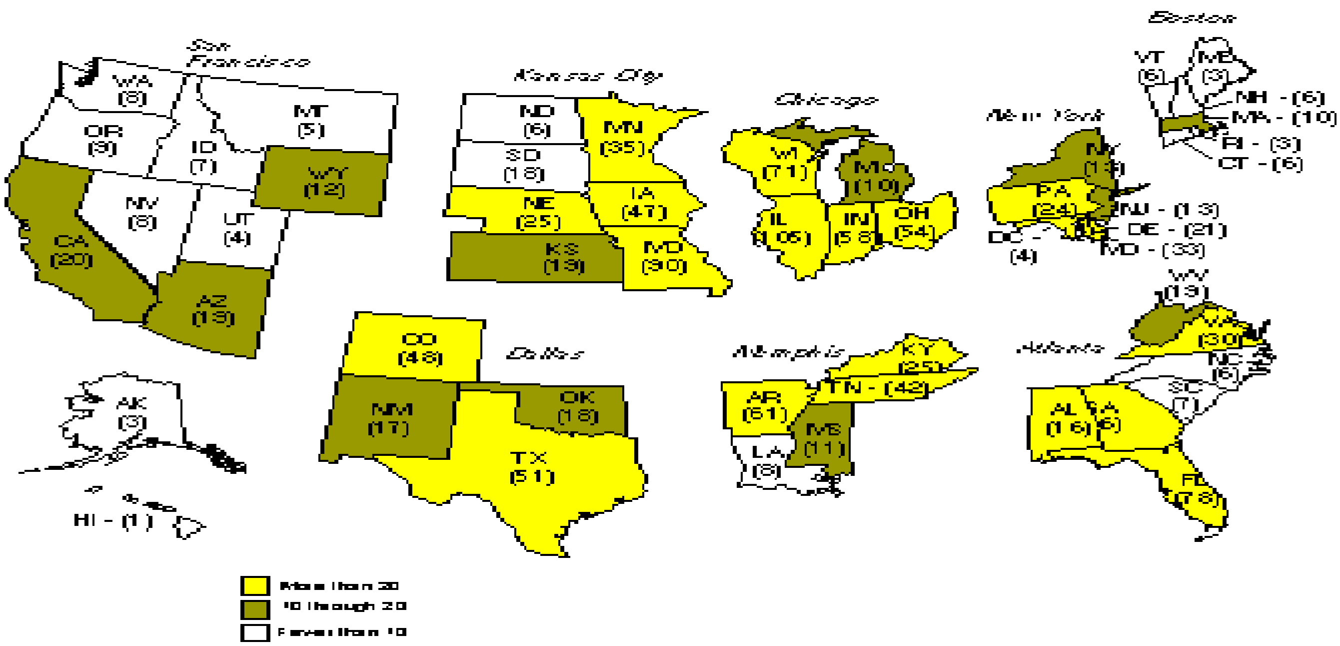
The full effect of the announced transactions on industry structure data will not appear for some time. As of August 5, 1996, 373 of the 443 announced transactions have been completed; 21 have been terminated. The largest announced deal of 1995 involved Chemical Banking Corp. acquiring Chase Manhattan Corp. with assets of approximately $118 billion, or nearly 24 percent of total assets covered by all 1995 announcements. This deal was completed on April 1, 1996.

The Future

It is fairly safe to predict that the interstate banking and industry consolidation trends have not run their course. These trends had been proceeding apace under previous law, and now have the additional spur of the Riegle-Neal Act. The real uncertainties regarding the future concern how much further the trends are likely to proceed and how their impacts may differ regionally and from state to state. In the following discussion, several approaches are taken to these issues.

Before the scenarios are presented, however, a caveat is in order. The expansion and consolidation opportunities opened by the Riegle-Neal Act will not necessarily be pursued by all, or even a majority, of banking organizations. This might be particularly the case with interstate branching. For a variety of managerial and competitive reasons, some banking organizations may prefer to conduct interstate operations through holding company structures rather than through branching systems. That is, instead of converting all of its banking offices to branches of a single bank, a holding company might want to maintain one or more legally distinct bank subsidiaries in states or banking markets in which it operates. Some multibank holding companies currently operate more than one commercial bank subsidiary within a single state even when branching laws would permit those in-state banks to be merged.

Figure 10
Minimalist Approach on a State-by-State Basis*



*The minimum consolidation scenario assumes that all existing multi-state banking organizations consolidate into a single lead bank, converting all other subsidiaries into branch offices. No other mergers are reflected in this scenario.

States are grouped into the eight FDIC DOS supervisory regions.

Sources: FRB NIC Database, FDIC DRS RIS Database

Region	Net Reduction in Institutions by Region
Boston	27
San Francisco	96
New York	108
Dallas	134
Memphis	147
Kansas City	240
Atlanta	232
Chicago	298

A banking organization may perceive competitive advantages in having community banks with local management, or in retaining the distinct identities and names of acquired banks. A banking organization may prefer to operate different businesses, such as credit cards or mortgage lending, out of separately chartered institutions. Some banking organizations may not agree that potential cost savings from converting banks into branches outweigh the advantages of operating multiple banks. Some banking organizations may choose to explore the possibilities of the "affiliate as agent" provision in Section 101 of the Riegle-Neal Act. This provision permits affiliated banks to receive deposits, renew time deposits, and collect loan payments for one another.

The point is that the Riegle-Neal Act only increases the structural alternatives available to banking organizations. Neither it nor the marketplace mandates that all banking organizations select an identical structure.

A Minimalist Approach

At midyear 1995, there were 303 banking organizations with interstate banking operations, representing 1,605 commercial banks and savings institutions with combined assets of $3.58 trillion. If each of these multi-state companies were to consolidate into a single lead bank or thrift and convert all other subsidiaries to branch offices, and no other interstate or intrastate transactions were to occur, the net reduction would be 1,302 institutions. The number of banks and thrifts would decline to 10,947, a reduction of 11 percent from the midyear 1995 total of 12,249 institutions (Table 6). For the FDIC, the net reduction in supervised institutions would be 322 out of 6,635.

A recent study finds that, due to the very favorable industry conditions since 1990, many banking organizations appear to have the strong performance and capitalization necessary to take advantage of future acquisition opportunities.[9] Although noting that it is difficult to know the extent to which future merger activity will be stimulated by the Riegle-Neal Act, the study finds that mergers and consolidations have risen in the past when state restrictions upon intrastate branching were relaxed.

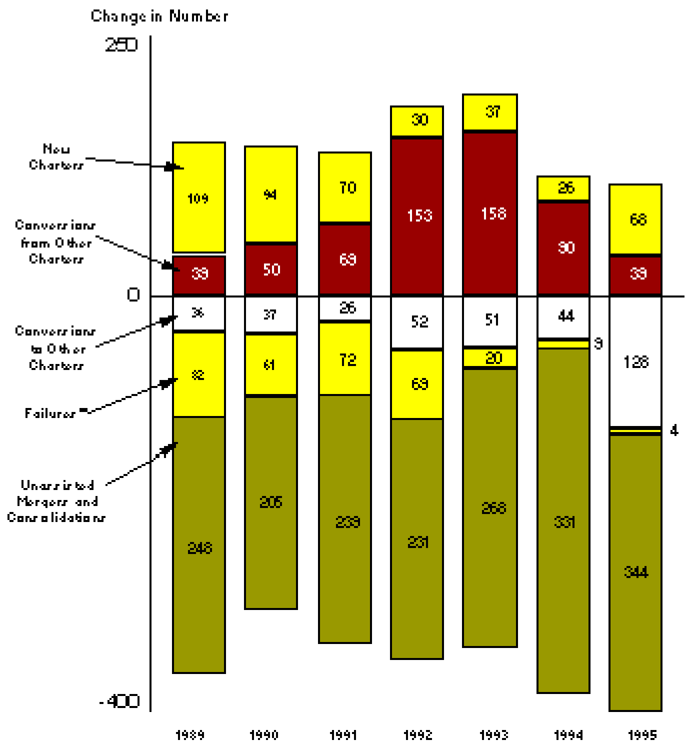
O'Keefe states that it is difficult, if not impossible, to predict which banks will combine operations through mergers, that is, to predict pairs of targets and acquirers. However, analyses of the financial characteristics of past target banks and acquirers show that one may be able to predict which banks are likely merger targets, and acquirers may then be used to infer the level of future merger activity.

An Extrapolation Approach

In a paper published in April 1995, Daniel Nolle, an economist with the Office of the Comptroller of the Currency, used an extrapolation approach to arrive at the total number of U.S. commercial banks that might exist in the year 2001.[10] Assuming that recent patterns of structural changes closings, de novo charters, thrift conversions, intra-company mergers, and inter-company mergers persist, Nolle arrives at a figure of 8,798 commercial banks at year-end 2000, a 19-percent reduction from 10,870 commercial banks at the end of 1993. Then, to allow for the impact of interstate branching, he increased the assumed rates of intra- and inter-company mergers, resulting in 7,787 commercial banks at the end of the year 2000, a 28-percent reduction over seven years. By way of comparison, if one simply takes the actual reduction in the number of commercial banks in 1993 504 banks and multiplies that number by seven (for the years 1994 through 2000), the result is a net reduction of 3,528 banks, or 32 percent.

Figure 11

Changes in the Number of FDIC-Supervised Institutions*



* Excludes 29 institutions that relinquished their charter and may have transferred operations to other charters.

** Failures do not include open-bank assistance transactions.

The Future of the Community Bank

A noteworthy aspect of the consolidation process over the past decade has been a decline in the number of small institutions. For example, there has been a 45-percent reduction in the number of banks and thrifts with less than $100 million in assets since 1984 (Table 5). The decline in the number of these small institutions accounts for the entire decrease in the number of insured commercial banks and savings institutions over that period. Given that the imminent arrival of interstate branching is expected to add momentum to the trends of industry consolidation, it may reasonably be asked whether the small community bank has a viable place in the future structure of the industry. This question is of interest to the FDIC in its supervisory role; the FDIC is the primary federal regulator for two out of every three insured institutions with less than $100 million in assets.

Four factors have contributed to the decline in the number of the smallest institutions. The most significant has been the number absorbed by unassisted mergers. Approximately 4,500 small banks and thrifts have been merged into larger institutions since 1984. A second factor has been growth. Since 1984, about 2,100 institutions have increased their assets above the $100-million asset-size threshold. Failures are the third factor. From 1985 through 1995, there were 1,599 failures of commercial banks and savings institutions with assets of less than $100 million. Finally, the number of new charters has declined, and new charters are issued most often for smaller institutions. Although 2,424 new charters were issued from 1985 through 1995, the number has trended steadily downward. In 1985, there were 598 new commercial banks and thrifts chartered. By 1994, the number of new charters had declined to 75. As more institutions are removed from the ranks of the smallest, fewer new institutions are replacing them.

Over half (61.4 percent) of the net reduction in the smallest institutions since 1984 has occurred in the 16 states that had restrictive branching laws but have since removed those restrictions. Branching restrictions tend to increase the number of new charters, which serve as substitutes for de novo branches. For example, four out of every five new commercial bank charters in 1985 occurred in one of the 31 states that restricted branching at that time; almost one-third were in a single unit banking state, Texas. The lifting of these restrictions has spurred the subsequent pace of merger and consolidation activity as more multibank holding companies are able to convert subsidiaries into branches.

If the decline in the number of smaller institutions is all that is considered, the future prospects of this segment of the banking industry might seem unpromising. The picture painted by the declining number, however, is incomplete. Smaller banks still are the most numerous category of institution. As of March 31, 1996, there were nearly 7,500 commercial banks and savings institutions with less than $100 million in assets, accounting for two out of every three FDIC-insured depository institutions. More than 95 percent of all insured institutions have less than $1 billion in assets. Although institutions with less than $100 million in assets together represent only 6.4 percent of industry assets, they held 22 percent of all loans to small businesses. [11] They operate in over 4,000 cities and towns in which there are no offices of larger banks, providing essential financial services to consumers and businesses.

Table 7
Number of FDIC-Insured Commercial Banks and Savings Institutions according to Primary Regulator*

Yr./ Qtr.	FDIC No.	FDIC %of Total	OCC No.	OCC %of Total	FRB No.	FRB %of Total	OTS** No.	OTS** %of Total	TOTAL
96:1	6,561	55.4	2,822	23.8	1,047	8.8	1,416	12.0	11,846
95:4	6,637	55.4	2,855	23.9	1,042	8.7	1,436	12.0	11,970
95:3	6,726	55.5	2,892	23.9	1,034	8.5	1,460	12.1	12,112
95:2	6,832	55.8	2,946	24.1	994	8.1	1,477	12.1	12,249
94:4	7,010	55.6	3,075	24.4	975	7.7	1,542	12.2	12,602

93:4	7,278	55.1	3,304	25.0	969	7.3	1,669	12.6	13,220
92:4	7,432	53.7	3,593	25.9	955	6.9	1,872	14.0	13,852
91:4	7,606	52.5	3,790	26.2	974	6.7	2,112	14.6	14,482
90:4	7,811	51.5	3,979	26.3	1,009	6.7	2,359	15.6	15,158
89:4	7,969	50.4	4,175	26.4	1,034	6.5	2,618	16.6	15,796
88:4	8,182	49.4	4,353	26.3	1,059	6.4	2,967	17.9	16,561
87:4	8,462	48.8	4,623	26.7	1,092	6.3	3,159	18.2	17,336
86:4	8,679	48.6	4,871	27.2	1,094	6.1	3,232	18.1	17,876
85:4	8,742	48.5	4,959	27.5	1,070	5.9	3,262	18.1	18,033
84:4	8,793	49.1	4,902	27.4	1,056	5.9	3,150	17.6	17,901
84:1	8,886	49.7	4,790	26.8	1,059	5.9	3,151	17.6	17,886

Assets of FDIC-Insured Commercial Banks and Savings institutions
(Dollars in Millions)

	FDIC		OCC		FRB		OTS**		
Yr./ Qtr.	Assets	%of Total	Assets	%of Total	Assets	%of Total	Assets	%of Total	TOTAL
96:1	$1,174,513	22.1	$2,398,414	45.0	$988,962	18.6	$762,851	14.3	$5,324,740
95:4	1,182,984	22.2	2,400,831	45.0	983,630	18.4	770,973	14.4	5,338,418
95:3	1,181,091	22.5	2,319,184	44.1	978,635	18.6	775,069	14.8	5,253,979
95:2	1,166,646	22.5	2,299,720	44.3	943,912	18.2	777,657	15.0	5,187,935
94:4	1,144,169	22.8	2,255,941	44.9	845,067	16.8	774,124	15.4	5,019,301
93:4	1,104,868	23.5	2,100,566	44.6	726,871	15.4	774,775	16.5	4,707,080
92:4	1,080,667	23.8	2,004,940	44.2	638,233	14.1	812,049	17.9	4,535,889
91:4	1,070,232	23.6	1,985,322	43.7	592,893	13.0	895,195	19.7	4,543,642
90:4	1,073,242	23.1	1,987,777	42.8	557,788	12.0	1,029,842	22.2	4,648,649
89:4	1,020,819	21.6	1,978,226	41.9	540,830	11.4	1,186,999	25.1	4,726,874
88:4	984,188	20.8	1,850,460	39.1	534,256	11.3	1,368,381	28.9	4,737,285
87:4	914,052	20.3	1,773,470	39.4	529,563	11.8	1,284,974	28.5	4,502,059
86:4	848,164	19.6	1,743,902	40.3	533,196	12.3	1,202,303	27.8	4,327,565
85:4	759,757	19.0	1,632,586	40.9	495,721	12.4	1,105,262	27.7	3,993,326
84:4	690,488	18.9	1,498,179	41.0	455,728	12.5	1,008,722	27.6	3,653,117
84:1	654,124	19.4	1,399,298	41.5	438,743	13.0	881,956	26.1	3,374,121

* Excludes institutions operating in RTC conservatorship.
** FHLBB prior to the enactment of FIRREA on August 9,1989.
Source: FDIC Division of Research and Statistics, RIS Database

Smaller institutions have demonstrated the ability to thrive in both large and small markets. Indeed, smaller institutions have flourished in states such as California, New York and Virginia where statewide branching has been allowed for many years. The recent performance of small banks and thrifts does not offer cause to doubt their future viability. In four of the last six years, and in four of the last six quarters through the first quarter of 1996, institutions with less than $100 million in assets have been more profitable than the industry average as measured by return on assets (ROA). In 1994, 1995, and through the first quarter of 1996, more than 95 percent of these institutions were profitable. More than half reported ROAs above 1.00 percent, and more than three-quarters had ROAs above 0.75 percent.

In summary, although the trend toward consolidation in banking appears likely to continue, data on bank performance suggest that the smaller banking organization, focused on service to a particular local community, taking advantage of competitive strengths resulting from that focus, can continue to prosper.

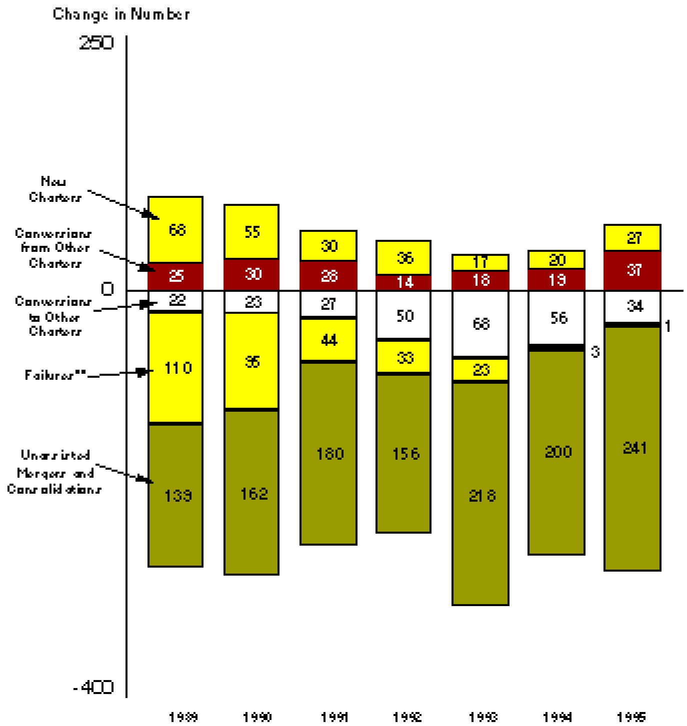
Impact on Supervision:

Background

In terms of numbers of institutions supervised, the consolidation process has affected all four federal regulators. As shown in Table 7, from the end of 1984 through the first quarter of 1996, the number of banks and thrifts supervised by the FDIC declined by 25 percent, from 8,793 to 6,561; the number of national banks supervised by the Office of the Comptroller of the Currency declined by 42 percent, from 4,902 to 2,822; the number of banks supervised by the Federal Reserve declined by one percent, from 1,056 to 1,047; and the number of savings institutions supervised by the Federal Home Loan Bank Board (FHLBB) and its successor, the Office of Thrift Supervision (OTS), declined by 55 percent, from 3,150 to 1,416.

Figure 12

Changes in the Number of OCC-Supervised Institutions*



* Excludes 19 institutions that relinquished their charter and may have transferred operations to other charters.

** Failures do not include open-bank assistance transactions.

As shown in Figures 11 through 14, different factors explain the decline in the number of institutions supervised by each regulator. Since the beginning of 1989 through 1995, the number of institutions supervised by the FDIC has declined by 1,334 (Figure 11). Nearly 1,900 FDIC-supervised institutions have been absorbed in unassisted mergers and consolidations (consolidations occur when multibank holding companies merge together their subsidiary banks). An additional 317 FDIC-supervised institutions failed and were closed. On the increase side, 434 new FDIC-supervised banks were chartered. A number of these new charters were issued in acquisitions of failing banks. During the same period, charter conversions resulted in 598 institutions switching to FDIC supervision from one of the other three federal regulators, and 374 FDIC-supervised institutions switching to another regulator, for a net gain to the FDIC of 224 institutions.

A large share of the institutions switching to FDIC supervision consisted of "Sasser" charter conversions by OTS-supervised savings associations.[12] Since the passage of FIRREA in 1989, SAIF-member savings associations regulated by the OTS have been able to convert their charters and become state savings banks regulated by the FDIC where state law permits, or they can become commercial banks regulated by one of the three federal bank regulators. As of March 31, 1996, the FDIC supervised 233 SAIF-member "Sasser" savings banks and 57 SAIF-member "Sasser" commercial banks that previously had been savings associations supervised by the OTS.

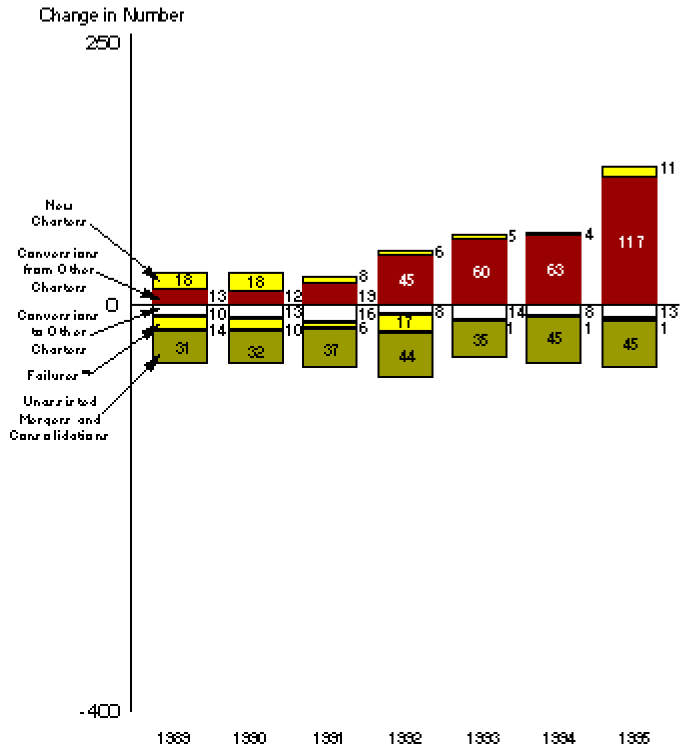
The OCC has experienced a similar decline 1,317 banks since 1989 in the number of institutions it supervises (Figure 13). If this reduction is expressed as a percentage, it is more than twice the decrease experienced by the FDIC (-31.5 percent, as compared with -16.7 percent), because the OCC supervises a smaller number of banks. As with the FDIC, the reduction in the number of institutions supervised by the OCC since 1989 has been due primarily to unassisted mergers and consolidations. The addition of 253 new charters and the conversions of 171 existing charters to OCC supervision were offset by the loss of 309 national banks to failures and 280 national banks converting to state charters.

In contrast, there has been a slight increase in the number of banks supervised by the Federal Reserve. At year-end 1995, the Federal Reserve supervised 1,042 state-chartered member banks, eight more than at the end of 1989. Increases from new charters (70) and conversions from other charters (329) have been matched by conversions of state member banks to other charters (82) and by absorptions of Federal Reserve-supervised banks in mergers and consolidations (269). There have been 50 failures of state member banks since 1989, accounting for the net decline in banks under Federal Reserve supervision.

The most dramatic reduction in institutions under supervision has occurred at the OTS (Figure 14). Although the net decline of 1,182 OTS-supervised savings institutions is smaller than the declines for the FDIC or the OCC, it represents a 45.2-percent decrease. The substantial reduction in the number of OTS-supervised savings institutions was initially due to failures but more recently has resulted from mergers and "Sasser" charter conversions. Unlike the case with the other three federal supervisory agencies, the impact of these losses has not been cushioned by the addition of new charters or conversions from other charters. From the beginning of 1989 through the end of 1995, 761 OTS/FHLBB-supervised institutions failed.[13] Another 502 institutions were absorbed by unassisted mergers and consolidations, while 370 savings associations converted to state savings banks supervised by the FDIC or commercial banks supervised by one of the three federal bank regulators. Only 89 new thrift charters were issued during this period.

Figure 13

Changes in the Number of
Federal Reserve Board-Supervised Institutions*



* Excludes 7 institutions that relinquished their charter and may have transferred operations to other charters.

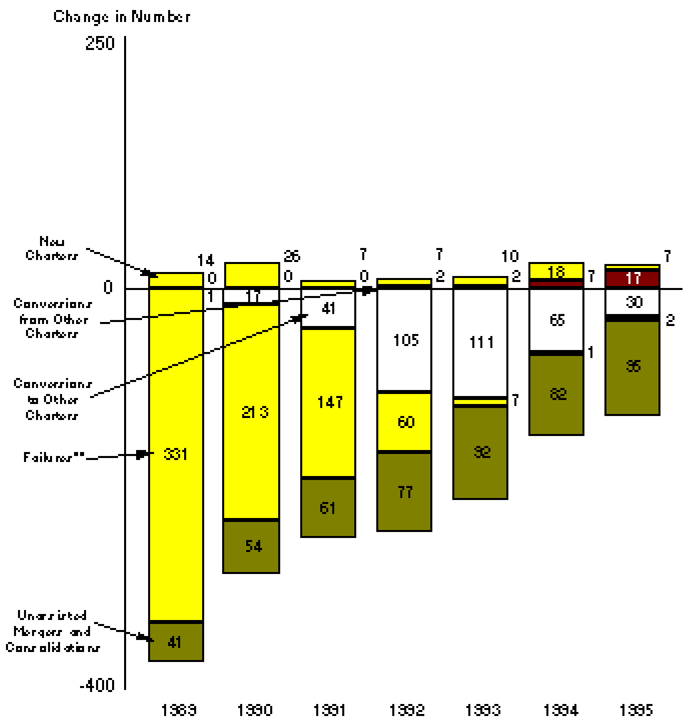
** Failures do not include open-bank assistance transactions.

It is clear from these trends that the factors determining the number of institutions unassisted mergers and acquisitions, failures, new charters, and charter conversions have affected each of the agencies differently. As a result, each agency's share of institutions supervised has shifted. The FDIC's share has shown the greatest increase, rising from 49.1 percent of insured banks and thrifts in 1984 to 57.1 percent as of March 31, 1996 (Table 7). The OTS/FHLBB share experienced the greatest decrease, declining from 17.6 percent in 1984 to 12.0 percent at year-end 1995. During the same period, the OCC's share declined slightly, from 27.4 to 23.8 percent, and the Federal Reserve's share rose modestly, from 5.9 to 8.8 percent.

The shifts in shares of the number of institutions regulated can be largely explained by changes in the thrift industry. If only commercial banks are considered, the shares of the three bank regulatory agencies show little movement (Table 8). Between year-end 1984 and the end of the first quarter of 1996, the FDIC's share of the number of commercial banks supervised increased from 58.9 percent to 60.1 percent, and its share of industry assets under supervision shrank slightly, from 22.1 percent to 21.4 percent. The OCC's shares of institutions and assets supervised both showed small declines, while the Federal Reserve's shares both rose slightly.

Figure 14

Changes in the Number of OTS-Supervised Institutions*



* Excludes 24 institutions that relinquished their charter and may have transferred operations to other charters.

** Failures do not include open-bank assistance transactions.

The portion of the thrift industry supervised by the OTS/FHLBB has decreased over the last ten years, while that of the FDIC has increased (Table 9). The decline in the OTS/FHLBB share is largely a result of financial difficulties experienced by thrifts in the 1980s. Much of the shift has occurred since the creation of the RTC in 1989, when large numbers of insolvent savings-and-loan associations began to be resolved. From August 1989 through July 1995, 745 insolvent OTS-supervised thrifts were resolved by the RTC. In addition, large numbers of OTS institutions have either been acquired without government assistance or have converted their charters and are now supervised by one of the other federal regulators. From the end of 1984 to the end of the first quarter of 1996, the OTS/FHLBB's share of thrifts supervised declined from 92.2 percent to 70.6 percent, while the FDIC's share rose from 7.8 percent to 29.4 percent. During this period, the OTS/FHLBB's share of thrift assets supervised declined from 88.2 percent to 75.1 percent, while the FDIC's share rose from 11.8 percent to 24.9 percent.

The shrinkage in the number of commercial banks during the past ten years has been accompanied by an increase in industry size as measured by total assets. All three banking regulators have experienced significant increases in assets under supervision since the end of 1984, even as the OTS/FHLBB experienced a decline (Table 7). Total assets under Federal Reserve supervision grew by 117 percent, while assets under FDIC supervision increased by 70 percent, and those under OCC supervision grew by 60 percent. Assets under OTS/FHLBB supervision declined by 24 percent. The three banking agencies all had minor increases in the share of assets supervised during this period. The FDIC's share rose from 18.9 percent to 22.1 percent; the OCC's share rose from 41.0 percent to 45.0 percent; and the Federal Reserve's share rose from 12.5 percent to 18.6 percent. The increases were at the expense of the OTS/FHLBB, which saw its share decline from 27.6 percent to 14.3 percent.

Table 8
Number of FDIC-Insured Commercial Banks
According to Primary Regulator

Yr./ Qtr.	FDIC No.	FDIC %of Total	OCC No.	OCC %of Total	FRB No.	FRB %of Total	TOTAL
96:1	5,972	60.7	2,822	28.7	1,047	10.6	9,841
95:4	6,044	60.8	2,855	28.7	1,042	10.5	9,941
95:3	6,126	60.9	2,892	28.8	1,034	10.3	10,052
95:2	6,228	61.3	2,946	29.0	994	9.8	10,168
94:4	6,400	61.2	3,075	29.4	975	9.3	10,450
93:4	6,685	61.0	3,304	30.2	969	8.8	10,958
92:4	6,914	60.3	3,593	31.3	955	8.3	11,462
91:4	7,157	60.0	3,790	31.8	974	8.2	11,921
90:4	7,355	59.6	3,979	32.2	1,009	8.2	12,343
89:4	7,500	59.0	4,175	32.9	1,034	8.1	12,709
88:4	7,711	58.8	4,353	33.2	1,059	8.1	13,123
87:4	7,999	58.3	4,623	33.7	1,092	8.0	13,714
86:4	8,234	58.0	4,871	34.3	1,094	7.7	14,199
85:4	8,378	58.2	4,959	34.4	1,070	7.4	14,407
84:4	8,525	58.9	4,902	33.8	1,056	7.3	14,483
84:1	8,610	59.5	4,790	33.1	1,059	7.3	14,459

Assets of FDIC-Insured Commercial Banks
(Dollars in Millions)

Yr./ Qtr.	FDIC Assets	FDIC %of Total	OCC Assets	OCC %of Total	FRB Assets	FRB %of Total	TOTAL
96:1	$920,960	21.4	$2,398,414	55.7	$988,962	23.0	$4,308,336
95:4	928,217	21.5	2,400,831	55.7	983,630	22.8	4,312,678
95:3	931,486	22.0	2,319,184	54.8	978,635	23.1	4,229,305
95:2	927,074	22.2	2,299,720	55.1	943,912	22.6	4,170,706
94:4	909,648	22.7	2,255,941	56.2	845,067	21.1	4,010,656
93:4	878,754	23.7	2,100,566	56.7	726,871	19.6	3,706,191
92:4	862,501	24.6	2,004,940	57.2	638,233	18.2	3,505,674
91:4	852,425	24.8	1,985,322	57.9	592,893	17.3	3,430,640
90:4	843,906	24.9	1,987,777	58.6	557,788	16.5	3,389,471
89:4	780,306	23.7	1,978,226	60.0	540,830	16.4	3,299,362
88:4	746,080	23.8	1,850,460	59.1	534,256	17.1	3,130,796
87:4	696,915	23.2	1,773,470	59.1	529,563	17.7	2,999,948
86:4	663,600	22.6	1,743,902	59.3	533,196	18.1	2,940,698
85:4	602,364	22.1	1,632,586	59.8	495,721	18.2	2,730,671
84:4	554,964	22.1	1,498,179	59.7	455,728	18.2	2,508,871
84:1	518,763	22.0	1,399,298	59.4	438,743	18.6	2,356,804

Source: FDIC Division of Research and Statistics, RIS Database

Three points summarize the trends in regulatory responsibilities over the last decade. First, the decline in the number of supervised institutions began with a wave of failures in the 1980s extending into the early 1990s. At the same time there was an increase in the pace of unassisted mergers that is still continuing and a sustained decline in new chartering activity. Second, mergers have increased the average sizes of supervised institutions[14] and have led to a greater concentration of industry assets. Supervisory responsibilities, as measured by assets under supervision, have increased at the three banking agencies. Third, except for the declines experienced by the OTS/ FHLBB, there has been little change so far among the three bank regulatory agencies in shares of institutions and assets supervised. This stability in bank regulators' shares will probably not continue in light of the recent trend in large company mergers. Major acquisitions announced during 1995 involve changes in ownership of 10.2 percent of all commercial bank and thrift assets.

Table 9
Number of FDIC-Insured Savings Institutions
According to Primary Regulator*

Yr./ Qtr.	FDIC No.	FDIC %of Total	OTS** No.	OTS** %of Total	TOTAL
96:1	589	29.4	1416	70.6	2,005
95:4	593	29.2	1436	70.8	2,029
95:3	600	29.1	1460	70.9	2,060
95:2	604	29.0	1477	71.0	2,081
94:4	610	28.3	1,542	71.7	2,152
93:4	593	26.2	1,669	73.8	2,262
92:4	518	21.7	1,872	78.3	2,390
91:4	449	17.5	2,112	82.5	2,561
90:4	456	16.2	2,359	83.8	2,815
89:4	469	15.2	2,618	84.8	3,087
88:4	471	13.7	2,967	86.3	3,438
87:4	463	12.8	3,159	87.2	3,622
86:4	445	12.1	3,232	87.9	3,677
85:4	364	10.0	3,262	90.0	3,626
84:4	268	7.8	3,150	92.2	3,418
84:1	276	8.1	3,151	91.9	3,427

Assets of FDIC-Insured Savings Institutions
(Dollars in Millions)

Yr./ Qtr.	FDIC Assets	FDIC %of Total	OTS** Assets	OTS** %of Total	TOTAL
96:1	253,553	24.9	762,851	75.1	1,016,404
95:4	254,767	24.8	770,973	75.2	1,025,740
95:3	249,604	24.4	775,069	75.6	1,024,673
95:2	239,572	23.6	777,657	76.4	1,017,229
94:4	234,521	23.3	774,124	76.7	1,008,645
93:4	226,114	22.6	774,775	77.4	1,000,889
92:4	218,166	21.2	812,049	78.8	1,030,215
91:4	217,807	19.6	895,195	80.4	1,113,002
90:4	229,336	18.2	1,029,842	81.8	1,259,178

89:4	240,513	16.8	1,186,999	83.2	1,427,512
88:4	238,108	14.8	1,368,381	85.2	1,606,489
87:4	217,136	14.5	1,284,974	85.5	1,502,110
86:4	184,563	13.3	1,202,303	86.7	1,386,866
85:4	157,392	12.5	1,105,262	87.5	1,262,654
84:4	135,524	11.8	1,008,722	88.2	1,144,246
84:1	135,361	13.3	881,956	86.7	1,017,317

* Excludes institutions operating in RTC conservatorship.
** FHLBB prior to the enactment of FIRREA on August 9, 1989.
Source: FDIC Division of Research and Statistics, RIS Database

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Table 6 illustrates how the drop in the number of smaller banks has coincided with an increase in the number of very large banks and the assets they hold. Between early 1984 and March 31, 1996, the number of banks and savings institutions with less than $1 billion in assets declined by almost one-third, from 17,433 to 11,267. During that period, their share of industry assets declined from 40.2 percent to 24.6 percent. In contrast, the number of institutions with more than $1 billion in assets increased from 453 to 579. The most significant increase in terms of industry asset share has taken place at the largest institutions. The number of institutions with over $10 billion in assets increased almost threefold, from 28 in 1984 to 87 as of March 31, 1996. The proportion of bank and thrift assets held by this relatively small number of large institutions increased from 28 percent to 48 percent.

Implications

Consolidation within multibank organizations may simplify some aspects of supervision by decreasing the number of federal regulators that have jurisdiction over a banking organization. For example, many bank holding companies have multiple bank subsidiaries. The regulator of each subsidiary is determined by the subsidiary's charter and, if the charter is from a state, the subsidiary's Federal Reserve membership status. Thus, each of the four federal bank and thrift regulators may supervise a portion of a multibank holding company. When banks or thrifts merge, the resultant institution has only one primary federal regulator. In the case of a holding company with national banks the resultant institution would have two federal regulators. Although interstate branching, to the extent it encourages such consolidation, may simplify federal jurisdictions, it will complicate the task of state bank supervisors. Branching across state lines will result in a number of banking organizations that must answer to more than one state authority.

Finally, attention to communications and information-sharing both within and between federal and state regulators will assume increasing importance as a nationwide banking system evolves and more institutions find themselves subject to multiple regulatory jurisdictions. Organizations as disparate as the Basle Committee on Bank Supervision and the Conference of State Bank Supervisors have recognized the need for regulatory agencies to communicate adequately with each other.

Table 10
Shifts of Federally Insured Depository Institutions Among Primary Federal Regulators If All Institutions Were Consolidated into Largest Institution Under the Top Holder (Regulatory High Holder)

(as of March 31, 1996; excludes IBAs)

	Number	Assets (Millions)	% of Total Number	% of Total Assets
Total	11,846	$5,324,740		
Institutions regulated by FRB on 3/31/96	1,047	988,962	8.8%	18.6%
Institutions that would be regulated by FRB	1,083	1,135,190	9.1	21.3
Current regulator				
FDIC	88	60,686		
FRB	895	860,960		
OCC	88	207,948		
OTS	12	5,595		
Institutions regulated by FDIC on 3/31/96	6,561	1,174,513	55.4	22.1
Institutions that would be regulated by FDIC:	6,177	984,126	52.1	18.5
Current regulator				
FDIC	5,987	954,937		
FRB	46	5,545		
OCC	116	17,608		
OTS	28	6,036		
Institutions regulated by OCC on 3/31/96	2,822	2,398,414	23.8	45.0
Institutions that would be regulated byOCC:	3,219	2,501,691	27.2	47.0
Current regulator				
FDIC	474	156,407		
FRB	981	20,984		
OCC	2,611	2,172,007		
OTS	36	52,293		
Institutions regulated by OTS on3/31/96:	1,416	762,851	12.0	14.3
Institutions that would be regulated byOTS:	1,367	703,733	11.5	13.2
Current regulator				
FDIC	12	2,483		
FRB	8	1,473		
OCC	7	849		
OTS	1,340	698,927		
Institutions shifiting to a new regulator:	1,013	637,909	8.6	12.0

* Excludes insured branches of foreign banks.
Source: FDIC Division of Research and Statistics

The final chart, Table 10, shows how the balance among the regulators would shift if all bank holding companies were to merge all of their bank and thrift subsidiaries into the "lead" bank.[15] It assumes that the largest subsidiary would retain its current charter and federal regulator. It is apparent that the consolidation process would bring many institutions under the supervision of new regulators. For example, 574 banks and thrifts that are currently regulated by the FDIC would be consolidated into "lead" banks supervised either by the Federal Reserve (88 banks), the OCC (474), or the OTS (12). At the same time, 190 banks that are currently regulated by the Federal Reserve (46), the OCC (116) or the OTS (28) would be consolidated into "lead" banks supervised by the FDIC.

FDIC Banking Review

Banking Industry Consolidation: Financial Attributes of Merging Banks
by John P. O'Keefe

Congress eliminated the remaining federal legal restrictions on interstate banking and branching in September 1994, with the passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal Act).[1] While many banking organizations had effectively circumvented legal barriers to interstate banking prior to the Riegle-Neal Act, they had to do so through the formation of multibank holding companies. Multibank holding companies may own and establish banks across states, provided they obtain a separate bank charter in each state.[2] Many industry observers expect, therefore, that the Riegle-Neal Act will facilitate the consolidation of multibank holding companies into multistate branch bank networks. Moreover, the reduced legal barriers to market entry might also encourage mergers between unaffiliated banking organizations. The potential for large structural change in the industry and the resultant reallocation of real and financial resources across markets is of interest to market participants and observers.

In order to analyze what form this structural change might take, this study draws upon merger and consolidation activity among depository institutions between January 1984 and June 1996. Merger and consolidation transactions for the period are used to develop financial profiles of participating banks. Next, those profiles are used to develop statistical models that predict the likelihood that a bank will become involved in a merger, either as the acquirer or target, in the near term. The Riegle-Neal Act represents an unprecedented change in the legal environment in which mergers occur. Empirical merger-prediction models draw upon known merger histories and cannot incorporate the effects that changes to the legal or regulatory environment might have upon mergers. Nevertheless, an understanding of the financial characteristics of many acquirers and target banks should be useful in predicting mergers and consolidations in the near term.

The merger forecasts presented here indicate that the current rapid pace of bank mergers and consolidations is likely to continue into the near future. In addition, the forecasts indicate a substantial divergence between the number of potential acquirers and target banks in several geographic regions. Consequently, the continued growth of interstate banking organizations is also likely. The first section of this study describes recent trends in mergers and consolidations, and discusses the impact of the thrift and banking crises during the 1980s upon industry restructuring. Section two reviews the incentives that bank owners and managers have to act upon the reduced legal restrictions on interstate banking. The potential for merger activity is examined in the third section. Specifically, the financial profiles of acquirers and targets in mergers and consolidations developed previously are used to form statistical models that relate the incidence of mergers and consolidations to important financial characteristics of banks. Those models are then used to predict the likelihood of an institution being a target bank or an acquirer in a merger or consolidation over a two-year horizon.

The study concludes with a discussion of the merger forecasts, as well as the geographic areas where interstate merger activity appears most likely to occur.

Recent Trends in Mergers and Consolidations

The recent legalization of full interstate branch banking could alter banking industry structure in two ways. First, many larger banking organizations used the multibank holding company organizational structure to form interstate banks before the passage of the Riegle-Neal Act. Some of these multibank holding companies might consolidate operations into multistate branch-bank networks if such networks offer advantages over existing organizational structures. Second, the ability to enter markets across state lines via branching might be a lower-cost alternative to the chartering of a new bank, as was required before the new legislation. Consequently, if barriers to market entry are reduced, there might be shifts in merger activity as banks implement their strategic merger plans.

The removal of legal impediments to interstate banking does not necessarily mean that more interstate banking organizations will develop. Mergers involve changes in ownership and, more importantly, can result in the reallocation of real and financial resources across markets. Such reallocations are motivated by the long-term expected risks and returns on invested capital. The present and expected future profitability of the industry will play an important role in such capital reallocations. In order to gain some perspective on what structural changes might occur, this section first examines recent merger and consolidation trends among depositories.

Table 1 shows the number of mergers and consolidations among commercial banks, savings banks and savings associations between January 1984 and June 1996. Mergers and consolidations were partitioned into five groups: (1) the formation of FDIC bridge banks; (2) RTC conservatorships; (3) FDIC-assisted failed-bank acquisitions; (4) FSLIC/RTC-assisted failed-thrift acquisitions; and (5) unassisted acquisitions. When a bank or thrift fails, the deposit insurer in its role as receiver has two general options to resolve the failure. The first is to liquidate the institution and compensate its creditors, particularly insured depositors; this type of resolution is known as a payoff. The second option is to sell some or all of the failed institution's operations intact to a financially sound bank or thrift; this type of resolution is known as a purchase-and-assumption transaction. The main criterion for selecting a resolution method is to select the method that is least costly to the deposit insurance fund.[3] Only those transactions that involve keeping some portion of the failed institution's franchise intact are included in Table 1.

Table 1
Mergers and Consolidations: January 1984 - June 1996
(All Commercial Banks, Savings Banks and Savings Associations)
Number and Percent of Regional Total

Region	FDIC Bridge Banks		RTC Conserva-torships		FDIC-Assisted		FSLIC/RTC-Assisted		Unassisted		Total
Northeast	1	0.1%	59	7.7%	119	15.4%	78	10.1%	514	66.7%	771

Mid-Atlantic	0	0.0	27	7.3	11	3.0	31	8.4	300	81.3	369
Southeast	1	0.1	132	7.7	75	4.4	155	9.1	1,344	78.7	1,707
Central	0	0.0	71	4.0	38	2.1	118	6.6	1,561	87.3	1,788
Midwest	0	0.0	59	4.0	190	12.9	75	5.1	1,152	78.0	1,476
Southwest	20	0.9	159	7.3	685	31.4	311	14.2	1,009	46.2	2,184
West	0	0.0	87	7.1	188	15.4	150	12.3	794	65.1	1,219
Islands	0	0.0	1	9.1	2	18.2	3	27.3	5	45.5	11
Total	22	0.2%	595	6.2%	1,308	13.7%	921	9.7%	6,679	70.1%	9,525

In some cases the government will take over ownership of the failed institution prior to arranging a merger with another bank or thrift (government-assisted mergers). This is included in Table 1 as bridge bank and conservatorship transactions. When the government eventually sells the bridge bank or conservatorship to another depository or sells the failed institution immediately upon closure to another depository, these are shown as either FDIC-assisted or FSLIC/ RTC-assisted mergers in Table 1. All other mergers and consolidations that do not involve the deposit insurers or the RTC are designated as unassisted mergers. Table 1 shows that unassisted mergers comprised 70.1 percent of all mergers and consolidations during the period. The remainder involved government-assisted acquisitions of failed banks and failed thrifts by healthy depositories.[4]

Table 2
Mergers and Consolidations
(All Commercial Banks, Savings Banks and Savings Associations)
Number and Percent of Yearly Total

Year	FDIC Bridge Banks		RTC Conserva-torships		FDIC-Assisted		FSLIC/ RTC-Assisted		Unassisted		Total
1984	0	0.0%	0	0.0%	75	15.6%	14	2.9%	393	81.5%	482
1985	0	0.0	0	0.0	94	18.4	33	6.4	385	75.2	512
1986	0	0.0	0	0.0	121	22.1	52	9.5	375	68.4	548
1987	0	0.0	0	0.0	176	21.0	54	6.5	607	72.5	837
1988	0	0.0	0	0.0	201	19.2	189	18.0	658	62.8	1,048
1989	0	0.0	34	4.1	197	23.9	138	16.7	455	55.2	824
1990	1	0.1	259	23.8	158	14.5	221	20.3	448	41.2	1,087

1991	0	0.0	166	17.6	118	12.5	145	15.3	516	54.6	945
1992	0	0.0	54	7.3	109	14.8	64	8.7	508	69.1	735
1993	20	2.9	23	3.4	37	5.4	8	1.2	594	87.1	682
1994	1	0.1	58	8.0	13	1.8	1	0.1	655	90.0	728
1995	0	0.0	1	0.1	6	0.8	2	0.3	723	98.8	732
June 1996	0	0.0	0	0.0	3	0.8	0	0.0	362	99.2	365
All	22	0.2%	595	6.2%	1,308	13.7%	921	9.7%	6,679	70.1%	9,525

Regional differences in merger activity during the period have been driven in large part by economic conditions, as well as by changes in state banking laws. For example, the regional recessions in the Southwest and Northeast in the late 1980s and early 1990s, respectively, contributed to the high proportions of government-assisted mergers in those regions. Table 2 also shows that both the number and proportion of unassisted mergers rose steadily after 1990 as the economy improved.

Another interesting aspect of industry restructuring is the proportion of industry consolidation that has involved affiliated versus unaffiliated banks. Table 3 identifies consolidations of multibank holding companies versus mergers between unaffiliated banks. Because historical information on thrift holding company affiliations was not available, savings associations are excluded from Table 3. The data show a marked increase in consolidation activity in 1995, driven partly by the recent relaxation of federal restrictions on interstate banking and branching.

TABLE 3
Mergers and Consolidations
Commercial Banks and Savings Banks
January 1984 - December 1995

Year	Consolidations With Holding Co. Number	Consolidations With Holding Co. (Yearly %)	Banks in Multibank Holding* Company	Non-afflicted Transactions Number	Non-afflicted Transactions (Yearly %)	Banks in One-Bank Holding Companies	Total Mergers
1984	107	(36.2%)	3,741	189	(63.9%)	11,032	296
1985	188	(44.4)	4,127	235	(55.6)	10,670	423
1986	165	(36.9)	4,510	282	(63.1)	10,159	447
1987	333	(46.4)	4,422	284	(53.6)	9,766	717

1988	420	(52.3)	4,226	283	(47.7)	9,388	803
1989	286	(46.7)	4,067	327	(53.3)	9,131	613
1990	286	(51.4)	3,925	271	(48.7)	8,892	557
1991	314	(55.3)	3,677	254	(44.7)	8,708	568
1992	264	(49.8)	3,474	266	(50.2)	8,522	530
1993	261	(47.9)	3,375	284	(52.1)	8,192	545
1994	298	(51.7)	3,287	278	(48.3)	7,790	576
1995	402	(65.2)	3,073	215	(34.9)	7,459	617
Total	3,324	(49.7%)		3,368	(50.3%)		6,692

*The number of banks in multibank holding companies, as well as in one-bank companies, are as of the calenday year-ends.

It is difficult to know what portions of the national merger trends seen in Tables 2 and 3 were driven by industry and regional economic conditions versus changes in federal and state banking laws. A state-by-state comparison of trends with associated changes in business and regulatory conditions would be too lengthy to present here. To gain some perspective on the impact that local economic conditions and changes in bank regulation can have upon merger activity, Tables 2b and 3b present bank and thrift merger trends for Texas depositories. Texas banking markets provide a useful illustration because of the severe changes in the state's economy and banking laws during the 1980s. Texas underwent a severe business downturn in the late 1980s. In addition, intrastate bank branching prohibitions in Texas were relaxed in 1987, permitting branching in contiguous counties; subsequently, statewide branching was permitted. Both events contributed to consolidations in Texas banking markets in the late 1980s and early 1990s.

Table 2b shows that merger activity in Texas increased sharply, from 41 to 233 transactions, between 1986 and 1987. Although a portion of this activity was due to commercial bank failures, most of the transactions involved unassisted mergers and consolidations. Table 3b shows that consolidations rose from 9 to 121 between 1986 and 1987. This increase was largely a result of the relaxation of state branching restrictions and consisted of unassisted transactions. Interestingly, mergers of non-affiliated banks between 1986 and 1987 also rose, from 23 to 96. While 45 of the 96 mergers in 1987 involved failed banks, the remaining 51 non-affiliate mergers represented a substantial increase over 1986 mergers.

Table 2b
Texas Mergers and Consolidations
(All Commercial Banks, Savings Banks and Savings Associations)

Number and Percent of Yearly Total

Year	FDIC Bridge Banks		RTC Conserva-torships		FDIC-Assisted		FSLIC/RTC-Assisted		Unassisted		Total
1984	0	0.0%	0	0.0%	6	40.0%	1	6.7%	8	53.3%	15
1985	0	0.0	0	0.0	10	47.6	0	0.0	11	52.4	21
1986	0	0.0	0	0.0	22	53.7	6	14.6	13	31.7	41
1987	0	0.0	0	0.0	45	19.3	5	2.1	183	78.5	233
1988	0	0.0	0	0.0	110	29.9	89	24.2	169	45.9	368
1989	0	0.0	8	3.4	131	55.3	39	16.5	59	24.9	237
1990	0	0.0	45	19.9	99	43.8	45	19.9	37	16.4	226
1991	0	0.0	28	27.2	30	29.1	10	9.7	35	34.0	103
1992	0	0.0	5	7.7	29	44.6	0	0.0	31	47.7	65
1993	20	23.8	0	0.0	10	11.9	0	0.0	54	64.3	84
1994	0	0.0	0	0.0	0	0.0	0	0.0	31	100.0	31
1995	0	0.0	0	0.0	0	0.0	0	0.0	51	100.0	51
June 1996	0	0.0	0	0.0	2	4.7	0	0.0	41	95.3	43
All	20	1.3%	86	5.7%	494	32.5%	195	12.8%	723	47.6%	1,518

Incentives for Mergers and Consolidations Merger Theory

There are two participants in all mergers, the acquiring firm and the target firm. Because of the high degree of regulatory oversight of bank mergers, nearly all bank mergers result from the joint decisions of the controlling directors and shareholders of both of the merging banks. A discussion of the decision on whether to merge should, therefore, consider both the acquiring and target bank's perspectives. This section reviews the potential motives underlying the merger decision, drawing upon the bank merger studies of Rose (1987), (1988).[5]

TABLE 3B
Texas Mergers and Consolidations
Commercial Banks and Savings Banks, January 1994 - December 1995

Consolidations	Banks in Multibanks	Non-afflicted	Banks in One-Bank

	Within Holding Co.		Holding	Transactions		Holding	Total
Year	Number	(Yearly %)	Companies*	Number	(Yearly%)	Companies	Mergers
1984	1	(16.7%)	757	5	(83.3%)	1,096	6
1985	7	(43.8)	819	9	(56.3)	1,117	16
1986	9	(28.1)	860	23	(71.9)	1,111	32
1987	121	(55.8)	675	96	(44.2)	1,091	217
1988	132	(47.5)	467	146	(52.5)	1,025	278
1989	50	(26.3)	323	140	(73.7)	990	190
1990	22	(16.4)	255	112	(83.6)	928	134
1991	19	(30.2)	223	44	(69.8)	898	63
1992	9	(16.1)	191	47	(83.9)	898	56
1993	24	(30.8)	172	54	(69.2)	839	78
1994	5	(16.1)	186	26	(83.9)	802	31
1995	15	(31.9)	193	32	(68.1)	755	47
Total	414	(36.1%)		734	(63.9%)		1,148

*The number of banks in multibank holding companies, as well as in one-bank campanies, are as of the calendar year-ends.

Merger motives can be classified into two broad categories: shareholder wealth maximization and managerial"well being." The notion that mergers are motivated by shareholder wealth maximization is a fundamental assumption of most economic theories on firm investment decisions. Under the wealth-maximization motive,mergers are treated like any other investment decision. Target firms in mergers are priced by bidders based upon the present discounted value of the expected returns on the acquisition, where the discount rate and return expectations consider the assumed firm's performance within the acquirer's portfolio of assets. In mergers, acquirers can share a portion of expected gains from the transaction with target firm owners to help encourage the merger. Such gains can result from post-merger improvements in the efficiency and profitability of the target bank's franchise or when the merged entity is expected to perform better than both of the individual firms. In either situation, the target bank's owners can be offered more than the current market value of their shares, because the "going concern value" of the target bank will be less than its value when combined with the acquirer's franchise.[6] If the merged firm has greater long-term market value than the simple sum of the parts, merger synergies are said to have occurred. Specific sources of merger synergies are risk diversification in revenues and costs, economies of scale and scope, and market power.

Investment theory shows that as one increases the number of assets in an investment portfolio whose returns are positively correlated, the total variance in the portfolio's return decreases and approaches the average covariance between individual asset returns.[7] If bank mergers increase portfolio diversification, the risk-reduction will benefit bank owners. The potential for increased geographic loan exposure diversification is probably the most likely source of benefits from interstate banking and branching. The regional concentrations of bank failures during the 1980s and 1990s were fueled by many banks' geographic lending concentrations, particularly those in commercial real estate.

Economies of scale refer to the ability to spread fixed operating costs over larger output levels, thereby reducing average total production costs. For example, bank mergers can reduce average costs when overlapping branch offices are closed, or fixed information processing costs and advertising costs are spread over increased revenues. In addition, personnel costs can be reduced when tasks overlap. Acquirers can benefit from applying "fixed" managerial and technical expertise to a larger business operation. Economies of scope are similar in nature, except that the cost savings result from applying fixed resources to a broader range of services, as opposed to simply increasing the level of the current mix of services. In addition, economies of scale can be achieved in financing. The costs of issuing debt and equity include a substantial fixed component. Consequently, larger banking organizations can spread fixed financing costs over larger equity issues, reducing per share issuance costs.

Mergers can also enhance market shares for acquirers for both balance-sheet and off-balance-sheet activities. This can confer some pricing advantages and improve profitability; however, there are limits to the extent to which mergers can be used to garner market power. Federal antitrust laws and regulatory policies restrict merger transactions in banking and other industries and are intended to prevent undue concentrations of market power. The primary federal antitrust laws that restrict merger activity are the Clayton Act of 1914, the Sherman Act of 1980 and the Federal Trade Commission Act of 1914. The Bank Merger Act of 1960, which was amended in 1966, clarifies federal bank regulators' role regarding bank merger policy. The U.S. Department of Justice (DOJ) and the Federal Trade Commission (FTC) are responsible for ensuring that bank merger transactions do not violate federal antitrust laws. The DOJ and the FTC have developed and published horizontal merger guidelines that present their policies and interpretation of appropriate merger practices.[8]

If a bank's owners or equity shareholders are not well represented on the firm's board of directors, the merger decision can be driven by managers' interests rather than those of shareholders. For example, managers seeking to protect their employment positions might actively block takeover attempts by many means, such as making preemptive acquisitions to ensure the firm is "too big to be a target." Since the assumed firm's management is often placed at risk of job loss in a merger, there is the potential for this motive to cause a divergence between shareholders' interests and managers' interests among targeted firms. The fact that managerial compensation usually increases with the revenues and assets of the firm also gives acquiring firms' managers an empire-building motive. This motive might not translate into increased wealth for their shareholders.

Finally, third-party influences on the merger decision can result in mergers with little or no benefit to either acquirers or target banks. Third parties involved in facilitating the transaction, such as investment bankers and securities dealers and underwriters, can profit from a merger transaction even when it does not produce the expected benefits to the acquiring firm's shareholders.[9] As Rose (1988) points out, with such a large and diverse array of possible motives for mergers it is not unexpected that empirical studies differ in explaining why mergers occur. One can expect that some combination of the previous factors have influenced bank mergers over the past decade. The empirical analysis of merger motives developed in this study draws upon the motive of shareholder wealth maximization.

Practical Considerations: Identifying Likely Targets and Acquirers

Banks that are actively seeking to expand operations through mergers can have unique characteristics that distinguish them from their peers. Businesses that are in an expansion mode should be perceived to be in sound financial condition and could be expected to be outperforming their peers. An adequate equity capital base and healthy profit rates are necessary to attract the additional capital often needed to finance mergers. Conversely, managements that are not successfully operating an organization could not be expected to do any better with expanded responsibilities and should not be engaged in mergers.

While these traits could be found among banks actively seeking mergers, such banks might not always be able to translate their abilities into action, that is, acquire other banks. One reason for inaction might be the lack of worthwhile merger candidates within a bank's geographic market or targeted new markets. State and federal restrictions on branching and interstate banking might also have limited the scope of merger candidates available to some banks. Prior to the Riegle-Neal Act, regional banking compacts limited banks' ability to acquire banks in states that did not have reciprocal agreements. Finally, a variety of factors, such as expectations of regional and national economic recessions, or constraints on existing managements' ability to assume new responsibilities, can delay merger activity. Thus, while acquirers could have common characteristics, these traits might also be present in banks not active in merger markets.

Similar generalizations might be possible for target banks in mergers. Target banks might be underperforming their peers and could benefit from mergers. Inefficient scale and scope of operations can, at times, only be overcome with difficulty when banks have limited access to capital markets. While target banks might be underperforming peers, one would not expect acquirers to seek out targets with substantial problems or weak franchises. Hence, targets are likely to have deficiencies that can be remedied without substantial cost to acquirers. Deficiencies need not always be present in target banks, however. One commonly cited example is that of owner-managers of closely held banks. These owners can choose takeovers as a means to cash out on their investment at retirement, particularly when leaving the business to family members is not a consideration. Finally, as with acquirers, to be a target bank implies that acquisition mode banks must exist within the target's geographic market or out-of-market acquirers must find the potential target's market attractive. While many target banks might have common traits, one can expect these traits also to be present among banks that have not yet become merger targets.

If one can identify potential acquirers and targets within markets, more might be said about the likelihood of future merger activity. One first needs to identify common traits of acquirers and target banks. This section looks at the financial characteristics of both groups in three ways. First, acquirers' and target banks' income statements and balance sheets are reviewed to learn whether certain attributes appear just before mergers occur, or whether they are longstanding. Second, comparisons of financial characteristics with peer groups are made to determine whether acquirers and targets differ from banks of similar size and location. Third, acquirers are compared with their targets to investigate possible motives for mergers such as portfolio diversification and improvements in operating efficiency.

The attractiveness of target banks' franchises to potential acquirers is influenced by market demographics, as well as current and expected future economic conditions in the local and regional markets. Demographic data and economic activity measures might aid in explaining merger activity. This study relied, however, upon the financial statements of banks, as well as bank examiners' assessments (CAMEL ratings) of banks' financial condition in analyzing merger activity. Both market demographics and business cycles affect financial statements; therefore, these factors are not entirely ignored when relying upon financial statements. Moreover, because the geographic scope of most banks' markets is not well known, relating merger activity to demographic and economic activity measures involves uncertainties. For example, high commercial property vacancy rates in a particular market might be expected to reduce the attractiveness of area target banks with substantial commercial real-estate loan exposures; however, banks do not report geographic loan exposures to federal bank regulators. Thus, the relevance of local vacancy rates to all potential target banks is uncertain. Banks do report nonperforming asset levels that directly show the effect of market conditions upon bank asset quality.

Peer Group Comparisons

In order to learn how acquirers and target banks differ from each other and their peers, a sample of 890 mergers occurring among commercial banks and savings banks between January 1984 and December 1995 was obtained. To help ensure that banks' financial profiles would not be distorted by the accounting changes that can appear with mergers and consolidations, acquirers were required to not have made acquisitions nor consolidations over the eight quarters prior to a merger.[10] All financial trends were tracked over the eight quarters prior to mergers. Second, only mergers between unaffiliated organizations were considered; consolidations of banks within the same holding company were excluded. Finally, all government-assisted mergers were excluded because of the unique nature of such mergers.[11] The characteristics of the sample of acquirers and their target banks are given in Tables 4, 5 and 6. As shown in these tables, the sample of mergers is fairly diverse across geographic regions and over time.

All comparisons of financial performance were made based upon mean values of income statement and balance-sheet variables, expressed as a percent of bank assets, or, for loan portfolio analysis, as a percent of gross loans and leases. Financial ratios were computed over each of the eight quarters prior to mergers. In order to determine whether the financial performance of acquirers and targets differed from that of their peers, samples of peer banks were selected for both groups. The peer groups consisted of banks of similar size, regional geographic location, and timing of financial data as the target banks (acquirers). Financial trends were computed using an abstract time measure, the number of quarters from a merger. As a result, each quarter consists of data "pooled" from several points in time for the 890 banks. For comparability, peer banks that had contemporaneous financial data with the target banks (acquirers) were selected. The mean values of several important financial ratios and their differences between groups of banks are available from the author upon request. The results of that analysis are summarized next.

Table 4
Sample of 890 Mergers Commercial Banks and Savings Banks, 1984 - 1995(Dollars in Billions)

Region	Acquirer Number	Location* (Percent)	Acquirers' Assets	Targets' Assets
Northeast	56	(6)	$72.6	$17.8
Mid-Atlantic	36	(4)	47.8	6.6
Southeast	138	(16)	115.9	7.3
Central1	40	(16)	39.1	9.0
Midwest	253	(28)	46.6	9.3
Southwest	140	(16)	63.2	16.4
West	127	(14)	226.0	75.2
Total	890	$611.3	$141.6	

* The regional locations of target banks were the same as those for their acquirers in all but one instance.

Table 5
Sample of 890 Mergers
Commercial Banks and Savings Banks 1984 - 1995

Asset Size	Acquirers Number	Acquirers (Percent)	Target Banks Number	Target Banks (Percent)
$5 Billion or More	20	(2)	3	(0)
$5 Billion to $1 Billion	64	(7)	15	(2)
$500 Million to $1Billion	57	(6)	10	(1)
$100 Million to $500Million	273	(31)	99	(11)
$50 Million to $100Million	185	(21)	127	(14)
$25 Million to $50Million	175	(20)	192	(22)
Under $25 Million	116	(13)	444	(50)
Total	890		890	

Income and Expenses

The sample of target banks had significantly higher average loan-loss provisions and total noninterest expenses than did their acquirers.[12] These higher expenses were not offset, on average, by interest and noninterest income among target banks. The result was a significantly lower average return on assets (ROA) among target banks than for their acquirers during the eight quarters before mergers took place. Net interest margins did not differ significantly between the sample of acquirers and their targets, however. The target banks were also typically much smaller than their acquirers. As a result, profit rates on assets (ROA) might differ due to bank size and capitalization. Targets could offset a lower ROA by increasing leverage; however, this will also increase the volatility in profits. This was not the case, however, because the target banks' equity capitalization was somewhat higher, on average, than that of their acquirers. In order to control for the effect of bank size on performance, peer bank comparisons also were made and are discussed next.

Table 6
Sample of 890 Mergers
Commercial Banks and Savings Banks
1984 - 1995

Year	Number	(Percent)	Median Ratio of Target-to-Acquirer Assets*
1986	77	(9)	22.3%
1987	93	(10)	30.2
1988	99	(11)	34.1
1989	68	(8)	28.1
1990	61	(7)	21.9
1991	77	(9)	27.8
1992	93	(10)	31.7
1993	103	(12)	26.3
1994	124	(14)	26.8
1995	95	(11)	22.4
Total	890		

*Asset values were measured as of the quarter-end prior to the merger.

Target banks had significantly higher rates of loan-loss provisioning and expenses on premises than did their peers. The result was that target banks' ROAs were significantly lower than those of their peers over most of the pre-acquisition period. Target banks were both less efficient than their peers and riskier based upon loan-loss provisioning. There were no significant differences between the net interest margins of target banks and their peers over the eight quarters prior to acquisition. Acquirers had significantly higher net interest margins than did their peers over the pre-acquisition period. Acquirers, however, did not have significantly different loan-loss provisions nor noninterest expenses than their peers. The result was that acquirers had marginally higher ROAs than did their peers during the pre-acquisition period, but the divergence in profit rates was not statistically significant.

Portfolio Composition: Assets

Target banks were, on average, significantly more liquid than their acquirers, with a greater proportion of their assets in cash balances, federal funds sold and resale agreements than their acquirers. Correspondingly, acquirers had significantly higher proportions of total assets comprised of gross loans and leases than did their targets. Acquirers might find target banks' liquid asset levels attractive because these assets can be turned into loans at low cost if lending opportunities exist. One negative aspect of targets was their significantly higher proportions of other real estate owned, which includes repossessed real estate, than those of acquirers.

Target banks had significantly higher proportions of their assets in cash balances, federal funds sold and resale agreements than did their peers; however, targets also had significantly lower levels of securities than did peer banks. Target banks also held significantly higher proportions of their assets in gross loans and leases. Moreover, as one might expect, target banks had higher levels of assets in bank premises and other fixed assets. This might explain the higher overhead expenses found for target banks as compared with their peers. Finally, target banks had higher asset concentrations in other real estate owned, which includes repossessed assets. This latter finding supports the prior statement that targets might be riskier, on average, than their peers in terms of the credit quality of assets.

Surprisingly, acquirers compared to their peers in much the same way that target banks compared to their peers. Acquirers had higher asset concentrations in cash balances, federal funds sold and resale agreements than did their peers. In addition, acquirers held lower proportions of assets in securities and more in gross loans and leases than did peer banks. Finally, acquirers had higher proportions of assets in premises and other fixed assets than their peers. However, there were no significant differences between acquirers and their peers with respect to levels of other real estate owned.

Portfolio Composition: Liabilities

There were several differences between acquirer and target banks' liability composition, as measured as a percent of total assets. Acquirers had slightly lower levels of deposit funding than did their target banks and relied more on federal funds purchased and repurchase agreements, other borrowed money, banks' liabilities on acceptances outstanding, and subordinated debt. Interestingly, acquirers had significantly higher levels of volatile liabilities than did target banks and, consequently, lower levels of core deposits. Acquirers might, therefore, seek target banks with a more stable core deposit base. Equity capitalization was slightly lower among acquirers than target banks, but the difference was not statistically significant in most instances. Because target banks were, on average, about one-quarter the asset size of their acquirers, one might have expected significantly higher capitalization for the small target banks than for the larger acquirers, based upon historical capitalization rates across bank size groups. This asset size difference can explain some of the divergence in liability composition difference between acquirers and targets.

Target banks had higher levels of total deposit funding than did their peers but no significant differences existed for other major liability items, including large time deposit accounts and brokered deposits. Target banks, however, did have significantly lower equity capitalization rates than their peers. Although acquirers' deposit funding levels were similar to those of their peers, acquirers relied significantly more on volatile liabilities. In addition, acquirers had higher levels of federal funds purchased and repurchase agreements than did peer banks. The higher reliance upon volatile liabilities among acquirers could be an important motivator in mergers. Finally, acquirers had significantly lower equity capitalization rates than their peers. Because one must judge capital adequacy in relation to a bank's entire operations, including important factors such as loan-loss reserves, nonperforming asset levels, and profitability, these lower capitalization rates do not necessarily imply acquirers had weaker capital positions than their peers.

Portfolio Composition: Loans

There were some significant differences in the loan concentrations of acquirers and their target banks. Comparisons of loan portfolio composition, as a percent of gross loans and leases, indicated that acquirers had a slightly different mix of loans than did target banks and acquirers appear to have somewhat riskier loan concentrations than target banks. Acquirers had significantly higher average loan-to-asset ratios than did target banks and higher concentrations of both short- and long-term commercial real- estate loans (construction and land development loans and loans secured by nonfarm nonresidential real estate) than did target banks. Acquirers also had significantly higher concentrations of commercial and industrial loans and municipal loans than did target banks. Conversely, acquirers had lower proportions of loans in 1-to-4 family residential mortgages, consumer loans and loans to officers, directors and principal shareholders (insider loans) than did their targets.

Target banks had significantly higher ratios of gross loans and leases to assets than their peers. Target banks differed from their peers primarily in terms of real-estate lending, with higher loan concentrations in all areas of real-estate loans, including commercial real estate, than that of peer banks. Acquirers had significantly higher ratios of gross loans and leases than their peers. Among major loan categories, acquirers were somewhat more heavily concentrated in real-estate loans, particularly loans secured by nonfarm nonresidential properties (long-term commercial real-estate loans).

Predicting Acquirers and Target Banks

The previous section indicated that the sample of acquirers and their target banks differed systematically from each other and their peers prior to mergers. If these differences in financial characteristics are common and persistent over time, as the prior analysis indicates, it might be possible to use this information to identify banks that will become acquirers or targets in mergers. This section presents the results of logit estimation of models predicting the likelihood of being an acquirer or target bank in a merger. Logit estimation is used to relate mergers, either from the acquirers' or target banks' perspective, to a number of the factors, both endogenous and exogenous to a bank that the previous analysis indicated can affect the incidence of mergers.[13] Because acquirers differ from their target banks, and both groups differ from their peers, separate logit estimations were obtained for acquirers and target banks.

Acquirers and their target banks appear to differ from their peers in terms of many important financial characteristics. Therefore, logit models were formed relating the incidence of mergers to the major attributes of banks' financial condition: capital adequacy, asset quality, management, earnings, and liquidity (henceforth, CAMEL attributes). Broad measures of bank condition were used in order to obtain models that would be robust across time and geographic regions. Therefore, details on loan portfolio composition and other factors likely to be correlated with time or location were excluded from the logit analysis.

To obtain general measures of condition, bank assets were partitioned into broad groups based upon earnings, liquidity, risk, and asset quality. Total assets were first partitioned into risk and nonrisk assets. Nonrisk assets were defined as the sum of cash balances due, securities, and federal funds sold plus resale agreements. Risk assets were, therefore, defined as total assets minus nonrisk assets. Nonrisk assets were further partitioned into two groups, noninterest-bearing nonrisk assets (that is, noninterest-bearing cash balances due) and interest-bearing nonrisk assets (that is, the sum of interest-bearing cash balances due, securities, and federal funds sold plus resale agreements). Risk assets were partitioned into performing and nonperforming risk assets. Nonperforming risk assets were defined as the sum of loans and leases past due 90 days or more, nonaccrual loans and leases, other real estate owned, and goodwill.

Two additional aspects of banks' asset portfolios were included in the analysis: lending levels and loan portfolio concentration. The proportion of banks' total assets comprised of loans and investment securities with maturities of five years or more was included as a measure of asset liquidity. In addition, a summary measure of loan-portfolio concentration was devised and included in the analysis. Specifically, total bank loans were divided into 15 well-defined categories of loans, which comprised nearly all of total loans. Next, the loan portfolio shares were obtained for these loan categories and the sum of squared shares were computed to form a concentration index analogous to the Herfindahl-Hirschman Index (HHI).[14]

The peer group analysis also indicated that measures of operating expense and profitability would be useful in predicting merger activity. Three components of noninterest expense were considered: expenses on salaries and employee benefits, expenses on fixed assets and premises, and all other noninterest expense. Bank profitability was measured by the return on earning assets (ROEA), which was defined as the ratio of operating income to earning assets. Operating income was measured by income before taxes and extraordinary items, gross of loan-loss provisions. Earning assets were defined as the sum of interest-earning cash balances, securities, federal funds and repurchase agreements sold, net loans and leases, and assets held in trade accounts, minus nonperforming assets.

Profitability and financial health are ultimately reflected in banks' capital adequacy; therefore, bank equity capital and loan-loss reserves were included in the models. Further, a bank's deposit franchise appeared to be an important factor in merger decisions. The main deposit measure considered was core deposits, defined as total deposits minus volatile liabilities. Volatile liabilities were defined as the sum of time deposits of $100,000 or more, all foreign-office deposits, federal funds purchased and securities sold under repurchase agreements, demand notes issued to the U.S. Treasury, and other borrowed money. Previous studies have also shown core deposit growth rates, as well as growth rates in gross loans and leases, might be important terms in predicting target banks.

Bank performance also varies systematically with bank asset size. It was hypothesized that the influence of asset size upon performance and condition decreases as total assets increase; therefore, the logarithm of bank assets was included as a size measure. In addition, de novo or recently established banks often have unusual financial characteristics when compared to established banks. These banks can also be precluded from being targets for a period after establishment by their chartering authority. Consequently, a de novo bank dummy variable, set equal to one for all banks in existence for three years or less (as of the model estimation date) and zero for all other banks, was included.

Because bank mergers require regulatory approval before transactions can proceed, bank regulators' assessments of banks' financial condition were particularly relevant to merger prediction. Bank regulators rate five aspects of banks' condition during periodic safety-and-soundness examinations: capital adequacy, asset quality, management, earnings, and liquidity. Banks receive ratings in each of the five CAMEL component areas that vary in integer levels from "1" to "5." Generally speaking, ratings of "3," "4," or "5" are given to banks considered to have moderate to serious deficiencies, respectively, that need to be addressed by bank management. These deficiencies can present risks that increase the chances of failure. Banks rated "1" are considered to be performing well-above-average, while a rating of "2" is given to banks with adequate performance, as dictated by regulatory safety-and-soundness standards. To gauge the extent of regulatory concern regarding banks' condition, the five CAMEL component ratings were included in the analysis using dummy variables set equal to one for banks rated "3," "4," or "5" for the component area and zero otherwise.

Equation 1 presents the most general form of the predictive equation, henceforth referred to as model 1.[15] Model 1 was used to predict the likelihood of being either an acquirer or a target bank. Model 1 was estimated separately for target banks and acquirers, yielding two different sets of coefficient estimates. Finally, to control further for systematic differences in condition measures across bank asset-size groups, all balance-sheet variables were measured as percents of bank assets, and income and expense items were measured as percents of average assets. A second model, which excluded the bank examination terms, was also tested and is presented below (model 2). Comparisons of models 1 and 2 allow one to see the additional information that bank examination ratings add to merger prediction.

A stepwise logit estimation procedure was used in all estimations. This procedure systematically identifies those terms that have a significant relationship with the likelihood of being an acquirer or target bank and excludes all other terms. This allows one to include several measures of the same attribute in the logit model, allowing the estimation procedure to isolate the most important factors in terms of predicting merger activity.

The samples of banks used in estimating the models consisted of all commercial banks and savings banks reporting financial data at year-ends between 1984 and 1995. Further, two different samples of "merger events" were used for estimating the models. In the first sample all unassisted mergers between unaffiliated banks, as well as consolidations of member banks of a multibank holding company (affiliates) were defined as merger events. Assisted mergers were not counted as merger events, but were, however, left in the population of all other nonmerging banks. The assisted mergers were excluded from the definition of merger events because identification of assisted target banks would yield bank-failure prediction models rather than the type of target-bank prediction models of interest to this study. As shown in Tables 1 and 2, the proportions of assisted transactions were quite high during part of the estimation period; therefore, the "failure-prediction" results could best be avoided by the exclusion of assisted transactions. In addition, while consolidations might be of interest to some groups, such consolidations do not alter the actual number of economic agents or banking firms. Therefore, a second sample of merger events was defined as all unassisted mergers between unaffiliated banks. Banks involved in consolidations and assisted mergers were, however, left in the population of nonmerging banks. By construction, these two samples of merger events will allow for predictions on both aspects of industry consolidation from the population of banks.

$$
\begin{aligned}
1.)\ \text{Likelihood of Merger}_{it,t+1} = {} & \beta_0 + \beta_1(\text{Interest-earning nonrisk assets})_{it-1} \\
& + \beta_2(\text{Noninterest-earning nonrisk assets})_{it-1} \\
& + \beta_3(\text{Performing risk assets})_{it-1} \\
& + \beta_4(\text{Loan portfolio concentration index})_{it-1} \\
& + \beta_5(\text{Total loans plus securities with maturities over 5 years})_{it-1} \\
& + \beta_6(\text{Expenses on salaries and benefits})_{it-1} \\
& + \beta_7(\text{Expenses on premises and fixed assets})_{it-1} \\
& + \beta_8(\text{All other noninterest expenses})_{it-1} \\
& + \beta_9(\text{Return on earning assets})_{it-1} \\
& + \beta_{10}(\text{Equity Capital})_{it-1} \\
& + \beta_{11}(\text{Loan-loss allowance})_{it-1} \\
& + \beta_{12}(\text{Core deposits})_{it-1} \\
& + \beta_{13}(\text{Core deposit growth})_{it-1} \\
& + \beta_{14}(\text{Gross loans growth rate})_{it-1} \\
& + \beta_{15}(\text{De novo bank dummy})_{it-1} \\
& + \beta_{16}(\text{Capital adequacy rating dummy})_{it-1} \\
& + \beta_{17}(\text{Asset quality rating dummy})_{it-1} \\
& + \beta_{18}(\text{Management rating dummy})_{it-1} \\
& + \beta_{19}(\text{Earnings rating dummy})_{it-1} \\
& + \beta_{20}(\text{Liquidity rating dummy})_{it-1} \\
& + \beta_{21}(\text{Logarithm of total assets})_{it-1} + e_{it}
\end{aligned}
$$

The models were estimated by relating year-end financial and related data, to the incidence of mergers and consolidations over the subsequent two years. Estimates were obtained separately for target banks and acquirers. Nine sets of estimates were obtained, starting with 1985 and ending at 1993. The stepwise logit estimations are presented in the Appendix in Tables A-1 through A-6. In interpreting the results, a positive (negative) coefficient estimate, k, implies that an increase in that variable will increase (decrease) the likelihood of being an acquirer (or target) bank.[16]

Tables A-1 through A-6 also give some indication of the accuracy of the prediction models. To do this, estimated probabilities of being an acquirer or target bank were obtained for each period. Next, a critical probability value was chosen and banks whose estimated transaction probabilities were above that critical value were labelled likely acquirers or targets. A critical probability value of five percent was used in all "in-sample" merger forecasts. The five percent value was chosen based upon a subjective judgment that this value yielded fair predictive power. Finally, another measure of logit models' explanatory power is the pseudo R2 statistic.[17] The pseudo R2 statistic is equal to 1 when the model perfectly predicts bank mergers, and zero when the explanatory variables provide no predictive information. For values between zero and 1, the pseudo R2 statistic measures "the percent of uncertainty in the data explained by the empirical results."[18]

Results of Logit Estimations

The results of the logit estimations were generally consistent with the profit-maximization, cost-reduction motives often given for mergers and consolidations. For brevity, the discussion will focus on positive results and will not attempt to explain why certain factors tested did not affect merger activity. Generally speaking, estimates of models 1 and 2 for target banks suggest that target banks had lower earnings, higher expenses on fixed assets and more liquid asset portfolios than non-target banks (all other banks). Table A-1 shows that the likelihood of being a target bank in an unassisted merger or consolidation increased with the proportion of liquid assets. In addition, the likelihood of being a target rose with expenses on premises and fixed assets, as well as with all other noninterest expenses. Interestingly, Table A-1 shows that the probability of being a target declined as expenses on employee salaries and benefits rose. This latter result, however, did not appear when consolidations were excluded from the definition of merger events (see Tables A-2 and A-3). The employee expense result in Table A-1 seems at odds with the cost-reduction motive for consolidations and might be related to high "trimming costs" that result from paying accrued benefits and severance pay when personnel is cut back. While such costs can occur with all mergers, in consolidations the willingness to incur such costs might play a larger role in decisions.

The coefficient estimates for the examination indexes for the five CAMEL component areas also suggest some additional characteristics of target banks. Comparisons of Tables A-1 and A-2 indicate that the likelihood of being a target in a consolidation decreases among banks with poorly rated management (Table A-1), but the management rating was not a factor in mergers of unaffiliated banks (Table A-2). The management rating might be expected to be related to acquirers' desire to keep some staff and management of assumed banks. The "human capital" value of the acquired banks' staff can come from knowledge of the local market or general experience and expertise. The result that target banks' management quality is not a determinant of mergers of unaffiliated banks could indicate acquirers' willingness to replace key staff.

Because the management of targets in consolidations is from the same holding company organization as the acquirers, the role of the management rating in Table A-1 might actually be driven by the overall organization involved in the consolidation. If this is the case, then the interpretation of the management rating among targets could have more to do with the acquirer side of the transaction. Results for the predictions of acquiring banks (Tables A-4 and A-5) show that the likelihood of being an acquirer decreases among banks with poor management ratings. This result is logical, given the importance of acquiring banks' management in obtaining regulatory approval of mergers, as well as shareholders' support. Tables A-1 and A-2 also show that the likelihood of being a target bank deceases the poorer the bank's earnings performance, perhaps indicating weaker franchises. In addition, comparisons of Tables A-1 and A-2 show that smaller banks are more likely to become targets in mergers of unaffiliated banks, but size is not a significant factor in consolidations. The results of model 2 in Table A-3 support the previous results and indicate the importance of some factors, such as earnings strength, to target-bank prediction can be captured by returns on earning assets or by examiners' ratings of earnings strength.

Tables A-4 through A-6 present similar tests of models relating banks' financial condition to the likelihood of being an acquirer in a merger or consolidation. Those results generally support the premise that acquirers are larger banks with well-rated management. Banks with more-liquid portfolios and lower loan concentration (loan HHI index) were also more likely to be acquirers. While these results agree with prior expectations regarding the characteristics of acquiring banks, the most striking result is how few factors were useful in predicting acquirers. Stated differently, the results clearly show how difficult it is to forecast merger activity. Of the 22 factors used to explain the characteristics of acquirers, only four appeared to be consistent in significance: asset size, liquidity, loan concentration, and the quality of management.

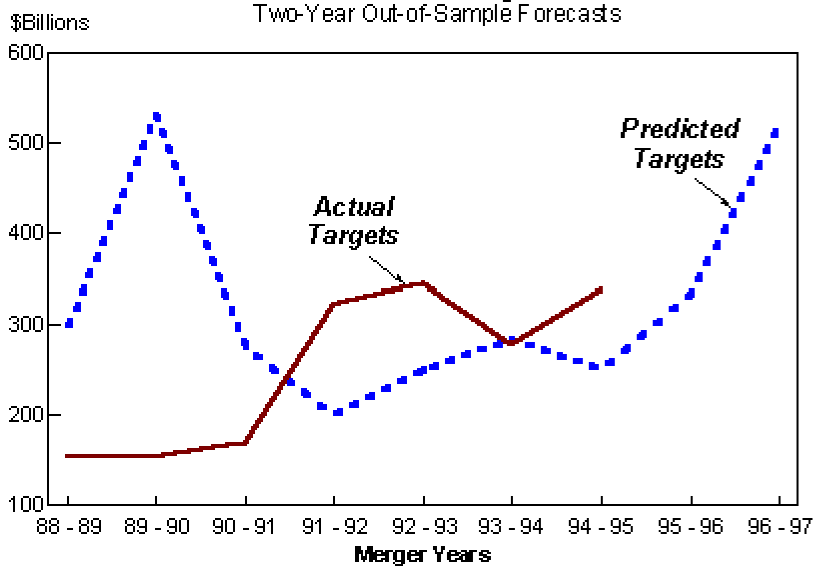
These results are consistent with a very common portrayal of bank mergers, whereby a large, well-run bank acquires a much smaller, less efficient bank. The target bank offers favorable attributes, such as liquidity. The acquirer is also able to correct any deficiencies of the target bank, thereby maintaining efficiencies for the combined organization. While this study does not investigate the post-merger performance of acquirers, the pre-merger profiles of targets and acquirers fit the scenario.

Forecasts of Acquirers and Targets

An important test of the usefulness of a forecasting model's predictive power is how well it predicts events that occur outside of the period used in estimating the model. For example, estimates obtained by logit estimations that related 1990 financial data to 1991 and 1992 merger events can be applied to 1992 financial data to forecast likely targets (acquirers) in 1993 and 1994. A series of such "out-of-sample" forecasts were made for the period 1987 to 1997 and are presented in this section. Forecasts on the number and asset size of the group of potential target banks and acquirers can be done in two ways. First, estimates of the probability of being a target can be obtained for an out-of-sample period for all banks. Second, all banks whose measured probabilities of being a target are above some critical probability value can be designated potential targets. Comparisons of actual targets with predicted targets will give an indication of model accuracy, much like the in-sample forecasts presented in Tables 1 through 3. The same approach can also be used to predict acquirers. One difficulty with this approach is the lack of any guide for selecting a critical probability. In practice, the lower the critical probability, the more likely one will correctly forecast actual targets or acquirers. However, this will also result in a large number of nonmerging banks being identified as targets or acquirers.

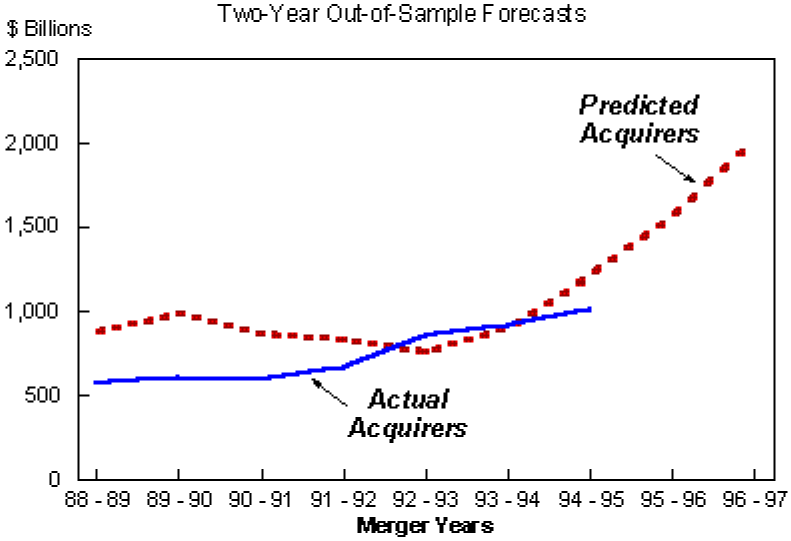
Because the models assign all banks some probability of being a target bank, one can simply take the sum of the predicted probabilities of being a target as the number of predicted targets during the two-year forecast period. While this alternative approach cannot be used to identify individual banks likely to be engaged in mergers, it can give an indication of the total level of merger activity predicted by the model. Whether these banks are large or small in asset size is also of interest. To measure the asset size of the potential target-bank group, one can multiply each bank's predicted probability of being a target by its total assets. Such statistical forecasts of the size of the target and acquiring bank populations were made for the period 1987 to 1997, based upon the logit estimations of unassisted mergers and consolidations (Tables A-1 and A-4). Those forecasts are shown in Figures 1 and 2, along with the size of the actual target and acquiring bank populations. More specifically, Figure 1 shows the asset size of all target banks as of the start of the two-year forecast period, as well as that of the forecasted targets. Figure 2 shows similar forecasts for acquirers.

Figure 1
Predicted *Versus* Actual Target Banks' Assets
Two-Year Out-of-Sample Forecasts



Figures 1 and 2 show that the asset sizes of groups of potential targets and acquirers have been rising since 1990. The same is true of groups of actual merging banks. There are two interesting aspects of these forecasts. First, the large overestimation of forecasted target banks for the 1989 to 1990 period (Figure 1). This result might be due, in large part, to the higher proportion of assisted mergers in those two years. Assisted mergers accounted for about half of all transactions in 1989 and 1990 (Table 2). The forecasts shown in Figures 1 and 2 are for unassisted transactions. Many banks that fit the profile of target banks might not have been acquired during 1989 and 1990 because acquirers made government-assisted acquisitions instead. Acquirers might prefer an assisted acquisition over an unassisted acquisition because of the risk-reducing assurances the government typically grants to failed-bank acquirers.[19] A second feature of the forecasts is the dramatic increase in the size of both the target and acquiring bank populations for the period 1996 to 1997. While the actual extent of mergers and consolidations will fluctuate with economic and regulatory events, Figures 1 and 2 indicate a substantial potential for continued industry consolidation in the near future.

Figure 2
Predicted *Versus* Actual Acquirers' Assets
Two-Year Out-of-Sample Forecasts



Note: Acquirers counted only once in cases where two or more mergers occurred during the period.

Changes in States' Banking Markets

The Riegle-Neal Act will undoubtedly contribute to the continued increase in interstate banking organizations, particularly through the advent of interstate bank branching. Many industry observers are, therefore, curious about which geographic regions will undergo the greatest change. Such information would be particularly helpful to state and federal bank regulators who wish to know the future demands upon their organizations. The previous sections showed the difficulties in profiling acquirers and target banks. Forecasting the geographic location of merger activity adds additional unknowns to the forecasting question by requiring one to know the likely pairs of targets and acquirers. Predicting pairs of merging banks is extremely difficult because those decisions are driven by the individual characteristics of both sides of the transaction. Statistical forecasts, however, are driven by the average attributes of groups. Consequently, this section looks at the geographic distribution of future merger activity indirectly, through forecasts of potential targets and acquirers at the state level.

Figure 3

Projections of Merger Activity: 1996-1997

Ratio of Projected Target-Bank Assets-to-Acquirer Ass

(All Commercial Banks and Savings Banks)

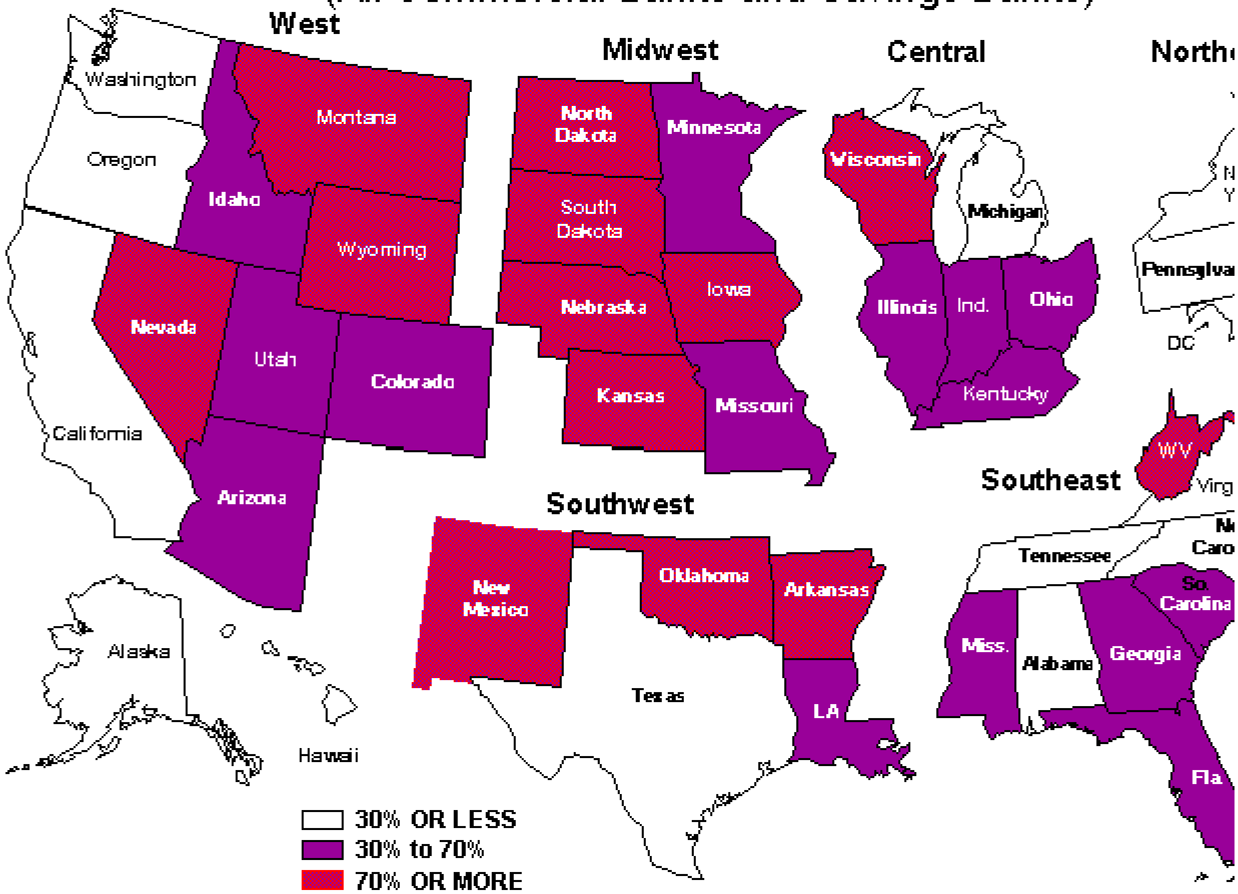


Figure 3 and Table 7 compare forecasts of the relative size of groups of potential targets and acquirers within each state for the period 1996 to 1997. Those forecasts were done using the same methodology outlined previously for national forecasts of unassisted bank mergers and consolidations. Target banks in mergers and consolidations are typically much smaller in asset size than acquirers. Table 6 showed that for a sample of 890 mergers between 1984 and 1995, the ratios of target-bank assets-to-acquirer assets averaged about 26 percent. To gauge the extent of potential targets and acquirers within each state, Figure 3 shows the ratio of forecasted target banks' assets to acquirers' assets within each state. There might be greater potential for interstate activity in regions where there is a high relative surplus of target banks, as indicated by a ratio of target-bank assets to acquirer assets much higher than the average rate of 26 percent.

Figure 1 shows the Midwest region has a high concentration of states where potential target banks' assets exceed 70 percent of potential acquirers' assets. Conversely, in regions where potential target banks are relatively few compared to potential acquirers, acquirers might be encouraged to look outside their geographic markets. Figure 3 shows this is the case in California and Texas, as well as in several large East Coast markets where potential target banks' assets averaged 30 percent or less than acquirers' assets. Following this line of reasoning, one might infer from Figure 3 forecasts of increased mergers between coastal banks and Midwestern banks in the near future. There are, however, some important caveats to such predictions. First, acquirers might not seek out small banks that fit the profiles of targets if market demographics are not attractive and offer limited growth opportunities. Second, the models this study develops can, at best, only give an indication of banks that have the attributes of acquirers and targets in mergers. Forecasting which banks will pair up in mergers requires more information than these statistical models can provide.

Table 7
Projected Acquirers and Target Banks: 1996 - 1997
Unassisted Mergers & Consolidations
Dollars in Thousands

State	Number of Banks	State Banking Assets	Projected Target Assets	Targets' State Assets Ratio	Projected Acquirer Assets	Projected Acquirer State Assets Ratio	Projected Number of Acquirers	Projected Number of Targets
AK	9	5,603,888	493,232	8.8	1,555,104	27.8	1.4	0.7
AL	186	56,322,295	6,149,388	10.9	27,535,026	48.9	12.8	15.5
AR	243	29,157,505	3,328,037	11.4	3,947,776	13.5	16.7	24.9
AZ	34	51,393,634	7,866,666	15.3	23,173,264	45.1	4.6	3.3
CA	383	368,222,678	42,646,860	11.6	246,549,406	67.0	29.8	36.4
CO	231	37,351,782	5,083,485	13.6	11,621,795	31.1	13.1	19.0
CT	86	66,818,979	9,746,381	14.6	23,148,034	34.6	7.1	8.9
DC	13	9,836,783	1,374,280	14.0	2,231,971	22.7	1.3	1.6
DE	42	111,177,750	3,539,376	3.2	6,672,123	6.0	2.2	2.8
FL	333	150,762,005	21,325,205	14.1	60,004,077	39.8	30.8	33.1
GA	383	132,670,009	25,315,300	19.1	69,383,306	52.3	27.4	34.2
HI	14	21,722,636	2,547,194	11.7	11,278,133	51.9	2.1	1.1
IA	491	42,018,384	4,567,017	10.9	8,265,976	19.7	25.2	46.4
ID	18	12,890,701	2,330,384	18.1	5,201,836	40.4	2.6	2.2
IL	917	244,479,856	26,336,931	10.8	80,644,262	33.0	56.4	86.7
IN	221	70,041,613	9,802,370	14.0	23,341,953	33.3	21.1	22.7
KS	433	31,428,922	3,578,873	11.4	4,961,034	15.8	18.0	37.8

KY	276	49,638,651	6,351,407	12.8	13,750,515	27.7	19.8	28.3
LA	190	46,221,952	4,849,155	10.5	13,249,696	28.7	12.8	17.3
MA	235	163,138,452	15,034,191	9.2	57,059,667	35.0	13.3	17.7
MD	93	69,033,564	8,662,148	12.5	34,804,499	50.4	9.3	8.5
ME	37	15,212,125	2,047,830	13.5	4,177,485	27.5	3.5	3.0
MI	180	118,900,391	15,425,932	13.0	65,769,103	55.3	16.2	16.1
MN	525	70,201,176	8,555,405	12.2	26,564,292	37.8	27.1	45.4
MO	459	80,481,252	14,834,989	18.4	31,330,691	38.9	31.0	44.8
MS	112	27,183,016	2,558,715	9.4	7,543,576	27.8	9.2	9.6
MT	104	8,193,543	963,920	11.8	1,854,750	22.6	5.1	8.4
NC	104	185,083,269	34,073,825	18.4	137,493,851	74.3	10.8	8.8
ND	127	8,036,833	785,129	9.8	1,096,467	13.6	5.8	10.8
NE	336	26,688,333	3,269,710	12.3	4,815,469	18.0	15.2	30.7
NH	42	17,763,748	3,996,050	22.5	4,154,242	23.4	3.2	4.6
NJ	110	121,721,651	15,039,922	12.4	52,692,790	43.3	11.3	10.5
NM	68	14,773,677	1,726,965	11.7	2,844,086	19.3	5.3	6.4
NV	25	26,334,174	2,106,497	8.0	3,954,798	15.0	2.3	2.0
NY	214	987,473,090	78,001,125	7.9	518,616,102	52.5	21.6	16.1
OH	287	162,398,816	22,490,673	13.8	70,605,006	43.5	26.5	28.6
OK	342	34,526,994	3,880,763	11.2	6,424,699	18.6	17.2	28.0
OR	45	31,570,733	4,249,998	13.5	15,703,178	49.7	5.5	3.3
PA	271	202,354,452	24,778,430	12.2	105,860,073	52.3	25.0	26.0
RI	11	22,708,039	2,644,297	11.6	10,814,279	47.6	1.9	0.8
SC	71	24,588,928	3,061,755	12.5	9,148,011	37.2	6.2	5.7
SD	116	28,614,803	633,473	2.2	513,370	1.8	4.5	9.0
TN	240	66,595,870	6,865,736	10.3	22,540,387	33.8	18.8	22.5
TX	948	210,076,213	22,519,635	10.7	82,562,199	39.3	53.8	84.8
UT	45	19,912,754	2,468,610	12.4	6,939,982	34.9	3.9	4.3

VA	158	77,818,910	7,401,301	9.5	32,086,378	41.2	13.5	15.0
VT	25	7,659,631	954,146	12.5	1,300,318	17.0	2.5	2.8
WA	99	74,214,908	12,243,496	16.5	44,599,653	60.1	10.4	8.1
WI	411	69,320,911	8,476,630	12.2	16,290,528	23.5	30.5	41.7
WV	118	21,255,773	2,177,964	10.2	3,874,201	18.2	7.6	10.8
WY	53	8,348,581	874,505	10.5	1,288,045	15.4	3.1	5.2
U.S. Total	10,514	4,539,944,633	520,035,306	11.5	2,021,837,462	44.5	725.9	962.9

*Note that all asset values were based upon December 1995 Call reports.

TABLE A-1

Model 1. - Predicting Targets in Mergers & Consolidations

Stepwise Logit Estimation of the Relationships Between Banks' Year-End Financial Condition and the Incidence of Mergers and Consolidations Over the Succeeding Two Years.

(FDIC-Assisted Mergers not classified as Mergers)

Estimated Coefficients (Standard Error)

Explanatory Variables	1985	1986	1987	1988	1989	1990	1991	1992	1993
Intercept	-14.6565	-8.3238	-1.2914	0.8515	-2.5419	-3.4490	-3.5004	-4.4129	-1.4954
	(2.0932)	(1.8343)	(0.1912)	(0.5576)	(0.1197)	(0.2711)	(0.2986)	(0.4977)	(0.1592)
Interest-Bearing Nonrisk Assets	0.1016	0.0734	-	-0.0284	-	-	-	-	-
	(0.0211)	(0.0182)		(0.0052)					
Noninterest-Bearing Nonrisk Assets	0.1586	0.1169	0.0425	-	0.0651	0.0583	0.0671	0.0621	0.0288
	(0.0234)	(0.0201)	(0.0117)		(0.0116)	(0.0118)	(0.0106)	(0.0116)	(0.0119)
Performing Risk Assets	0.1292	0.1011	0.0260	-	-	-	-	-	-
	(0.0215)	(0.0181)	(0.0051)						
Loan Portfolio Concentration (HHI)	-	-0.0001	-0.0001	-0.0001	-	-	-	-	-0.0001
		(0.00004)	(0.00003)	(0.00004)					(0.00003)

Total Loans plus Securities	-0.0187	-0.0343	-0.0277	-0.0211	-	-	-	-	-
with >= 5 yrs maturity	(0.0074)	(0.0058)	(0.0052)	(0.0054)					
Expense on Salaries	-0.5489	-0.7900	-1.1888	-0.7964	-0.6928	-0.6459	-0.5842	-0.6311	-0.7580
and Benefits	(0.0745)	(0.0851)	(0.0949)	(0.0841)	(0.0809)	(0.0884)	(0.0848)	(0.0835)	(0.0797)
Expense on Premises	0.7369	0.5554	0.6779	-	-	0.6687	0.4559	0.5536	0.3629
and Fixed Assets	(0.1106)	(0.1205)	(0.1342)			(0.1438)	(0.1538)	(0.1582)	(0.1686)
All Other Noninterest	0.3942	0.4095	0.3247	0.2832	0.4356	0.3417	0.1873	0.1771	0.3090
Expense	(0.0507)	(0.0553)	(0.0538)	(0.0338)	(0.0446)	(0.0443)	(0.0351)	(0.0391)	(0.0423)
Return on Earning	-	-0.1838	-0.1024	-0.1465	-	-	-	-	-0.0743
Assets		(0.0322)	(0.0311)	(0.0262)					(0.0310)
Equity Capital	-	-	-	-	-	-	-	-	-
Loan-Loss Allowance	-	0.1612	0.1616	-	-	0.2356	0.2334	0.2480	0.2382
		(0.0552)	(0.0493)			(0.0501)	(0.0480)	(0.0519)	(0.0507)
Core Deposits	-	-0.0134	-	-	-	0.0065	0.0092	0.0142	-
		(0.0025)				(0.0032)	(0.0035)	(0.0036)	
Core Deposit Growth	-	-	-	-	-	-	-	-	0.0010
									(0.0004)
Growth in Gross Loans	-	-	-	-	-	-	-	-	-
De Novo Bank Dummy	-0.4653	-0.5728	-	-	-	-	-	-	-
	(0.1843)	(0.1745)							
Supervisory Concern	-	-	-	-0.4513	-	-0.2678	-	-	-
for Capital Dummy				(0.1317)		(0.1197)			
Supervisory Concern	-	-	-	-	-	-	-	-	-
for Asset Quality Dummy									
Supervisory Concern	-	-0.3865	-0.4438	-0.3366	-	-0.3290	-0.2460	-0.2149	-0.4336
for Management Quality Du		(0.0923)	(0.0951)	(0.1130)		(0.1041)	(0.0923)	(0.0888)	(0.0980)
Supervisory Concern	-	-	0.1901	0.4982	-	0.3831	0.4713	0.4263	0.2438
for Earnings Dummy			(0.0838)	(0.0919)		(0.0934)	(0.0885)	(0.0859)	(0.0945)

	1985	1986	1987	1988	1989	1990	1991	1992	1993
Supervisory Concern for Liquidity Dummy	-	0.2757	-	-	-	-	-	-	-
		(0.1061)							
Log of Total Assets	0.0947	0.0710	-	-	-	-	-	0.0697	-
	(0.0297)	(0.0297)						(0.0274)	
2x Log of Likelihood	5875	7082	6646	5647	5705	5864	6085	6678	7213
Number of Observations	13,822	14,037	13,642	13,081	12,715	12,395	12,024	11,659	11,272
Pseudo R2	0.040	0.065	0.047	0.040	0.027	0.037	0.032	0.032	0.031
In-Sample of 10% Critical Probability									
Correct Predictions (%)									
Targets	18.7	45.5	36.1	18.2	14.2	24.9	28.7	41.1	63.1
Nontargets	92.7	83.1	86.5	93.3	95.6	91.1	87.0	77.2	58.3
Incorrect Predictions (%)									
False Failures or Type I	7.3	16.9	13.5	6.7	4.4	8.9	13.0	22.8	41.7
Missed Failures or Type I	81.3	54.5	63.9	81.8	85.8	75.1	71.3	58.9	36.9
Total Correct Predictions (%)	88.5	80.2	82.9	88.8	90.6	86.6	82.8	74.1	58.8
Number of Targets	801	1,072	965	775	783	830	878	1,016	1,154
Number of Nontargets	13,021	12,965	12,677	12,306	11,932	11,565	11,146	10,643	10,119

Table A-2
Model 1 - Predicting Targets in Non-affiliate Mergers
Stepwise Logit Estimation of the Relationships Between Banks' Year-end Financial Condition
and the Incidence of Mergers Over the Succeeding Two Years.
(Consolidations and FDIC-Assisted Mergers Not Classified as Mergers)
Estimated Coefficients (Standard Errors)

Explanatory Variables	1985	1986	1987	1988	1989	1990	1991	1992	1993

Intercept	-5.6309	-3.2043	-1.0598	-4.2086	-0.7494	-0.7118	-1.6850	-1.8376	-3.0233
	(0.4245)	(0.2347)	(0.7064)	(1.0652)	(0.7197)	(0.6216)	(0.5133)	(0.4645)	(0.2228)
Interest-Bearing Nonrisk Assets	--	--	-0.0264	--	--	--	--	--	--
			(0.0072)						
Noninterest-Bearing Nonrisk Assets	0.0531	0.0493	--	0.0389	0.0446	--	0.0380	0.0384	--
	(0.0132)	(0.0116)		(0.0196)	(0.0189)		(0.0126)	(0.0146)	
Performing Risk Assets	--	0.0240	--	--	--	--	--	--	--
		(0.0086)							
Loan Portfolio Concentration (HHI)	--	--	--	--	--	--	--	--	0.0001
									(0.00003)
Total Loans Plus Securities with >= 5 yrs Maturity	--	-0.0318	-0.0344	--	--	--	-0.0094	-0.0111	-0.0138
		(0.0088)	(0.0077)				(0.0040)	(0.0036)	(0.0033)
Expense on Salaries and Benefits	--	--	--	--	--	--	--	--	--
Expense on Premises and Fixed Assets	0.5498	--	--	--	--	--	0.2409	--	--
	(0.0999)						(0.1079)		
All Other Noninterest Expense	--	--	--	0.0966	0.1093	0.1501	--	--	--
				(0.0390)	(0.0513)	(0.0387)			
Return on Earning Assets	--	-0.1727	--	--	--	--	--	--	--
		(0.0306)							
Equity Capital	--	--	--	--	--	--	--	--	--
Loan-Loss Allowance	--	--	--	--	--	--	0.2510	0.1628	0.2067
							(0.0653)	(0.0704)	(0.0631)
Core Deposits	0.0158	--	--	0.0217	--	--	--	--	--
	(0.0050)			(0.0076)					
Core Deposit Growth	--	--	--	--	--	--	--	--	--
Growth in Gross Loans	--	--	--	--	--	--	--	--	--
De Novo Bank Dummy	--	--	--	--	--	--	--	--	--
Supervisory Concern for	--	--	--	--	--	--	--	--	0.3752

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Capital Dummy					(0.1516)				
Supervisory Concern for Asset Quality Dummy	--	--	--	--	--	0.4802	0.4651	0.3618	--
						(0.1471)	(0.1359)	(0.1234)	
Supervisory Concern for Management Quality Dummy	0.3625	--	--	--	--	--	--	--	--
	(0.1155)								
Supervisory Concern for Earnings Dummy	--	--	0.5912	0.5999	0.5115	0.6305	0.4400	0.7165	0.7940
			(0.1206)	(0.1382)	(0.1430)	(0.1485)	(0.1329)	(0.1156)	(0.1173)
Supervisory Concern for Liquidity Dummy	--	0.3835	--	--	--	--	--	0.3154	--
		(0.1440)						(0.1469)	
Log of Total Assets	--	--	--	-0.2014	-0.3684	-0.3480	-0.1975	-0.1351	--
				(0.0668)	(0.0661)	(0.0576)	(0.0463)	(0.0407)	
-2x Log of Likelihood	3206	3355	2810	2223	2091	2537	3168	3772	3768
Number of Observations	13,822	14,037	13,345	13,081	12,715	12,115	12,024	11,659	11,272
Pseudo R2	0.020	0.028	0.018	0.030	0.034	0.052	0.045	0.046	0.036
In-Sample at 4% Critical Probability									
Correct Predictions (%)									
Targets	15.4	22.2	5.4	7.9	13.6	38.2	42.7	56.6	49.8
Nontargets	93.0	91.1	96.6	97.4	96.9	86.4	78.6	69.1	72.5
Incorrect Predictions (%)									
False Targets or Type II Error	7.0	8.9	3.4	2.6	3.1	13.6	21.4	30.9	27.5
Missed Targets or Type I Error	84.6	77.8	94.6	92.1	86.4	61.8	57.3	43.4	50.2
Total Correct Predictions (%)	91.1	89.3	94.6	95.8	95.5	85.3	77.5	68.6	71.6
Number of Targets	351	374	297	227	213	280	372	472	470
Number of Nontargets	13,471	3,663	13,345	12,854	12,502	12,115	11,652	11,187	10,803

Table A-3
Model 2 - Predicting Targets in Non-affiliate Mergers
Stepwise Logit Estimation of the Relationships Between Banks' Year-end Financial Condition
and the Incidence of Mergers Over the Succeeding Two Years.
(Consolidations and FDIC-Assisted Mergers Not Classified as Mergers)
Estimated Coefficients (Standard Errors)

Explanatory Variables	1985	1986	1987	1988	1989	1990	1991	1992	1993
Intercept	-5.6860	-3.2075	-2.6312	-0.8507	-0.2565	-0.4328	-1.8917	-1.8731	-2.1432
	(0.4264)	(0.2337)	(0.5478)	(0.6630)	(0.7052)	(0.6148)	(0.5002)	(0.4600)	(0.4522)
Interest-Bearing Nonrisk Assets	--	--	--	--	--	--	--	--	--
Noninterest-Bearing Nonrisk Assets	0.0533	0.0494	0.0547	0.0400	0.0512	--	0.0504	0.0411	--
	(0.0130)	(0.0116)	(0.0164)	(0.0187)	(0.0182)		(0.0124)	(0.0149)	
Performing Risk Assets	--	0.0228	--	--	--	--	--	--	--
		(0.0086)							
Loan Portfolio Concentration (HHI)	--	--	--	--	--	--	--	--	0.0001
									(0.00003)
Total Loans Plus Securities with >= 5 yrs Maturity	--	-0.0293	--	--	--	--	--	-0.0074	-0.0109
		(0.0087)						(0.0035)	(0.0035)
Expense on Salaries and Benefits	--	--	--	--	--	--	--	--	--
Expense on Premises and Fixed Assets	0.5631	--	--	--	--	0.2709	0.3398	0.4089	0.4173
	(0.0974)					(0.1138)	(0.0993)	(0.1296)	(0.1375)
All Other Noninterest Expense	--	--	--	--	0.1371	0.1273	--	--	--
					(0.0446)	(0.0461)			
Return on Earning Assets	--	-0.1827	-0.1227	-0.1313	--	-0.0761	--	-0.0925	-0.1251
		(0.0292)	(0.0311)	(0.0332)		(0.0228)		(0.0304)	(0.0379)
Equity Capital	--	--	--	--	--	--	--	--	--
Loan-Loss Allowance	--	--	--	--	--	0.2507	0.3878	0.3628	0.3226
						(0.0721)	(0.0564)	0.0605)	(0.0607)

Core Deposits	0.0178	--	--	--	--	--	--	--	--
	(0.0050)								
Core Deposit Growth	--	--	--	--	--	--	--	--	--
Growth in Gross Loans	--	--	--	--	--	--	--	--	--
De Novo Bank Dummy	--	--	--	-1.2575	--	--	--	--	--
				(0.5865)					
Log of Total Assets	--	--	-0.1236	-0.3002	-0.4028	-0.3561	-0.2205	-0.1348	-0.0834
			(0.0505)	(0.0623)	(0.0655)	(0.0576)	(0.0452)	(0.0408)	(0.0405)
-2x Log of Likelihood	3240	3391	2829	2253	2110	2571	3218	3847	817
Number of Observations	13,928	14,110	13,695	13,116	12,740	12,412	12,035	11,660	11,272
Pseudo R2	0.017	0.024	0.012	0.024	0.029	0.040	0.030	0.027	0.023
In-Sample at 4% Critical Probability									
Correct Predictions (%)									
Targets	12.7	19.1	5.1	7.0	8.9	24.3	32.3	56.4	60.4
Nontargets	94.8	92.5	97.7	98.6	98.0	93.5	85.1	64.8	60.0
Incorrect Predictions (%)									
False Targets or Type II Error	5.2	7.5	2.3	1.4	2.0	6.5	14.9	35.2	40.0
Missed Targets or Type I Error	87.3	80.9	94.9	93.0	91.1	75.7	67.7	43.6	39.6
Total Correct Predictions (%)	92.7	90.5	95.7	97.0	96.5	91.9	83.5	64.5	60.0
Number of Targets	354	377	297	229	214	280	372	472	470
Number of Nontargets	13,574	13,733	13,398	12,887	12,526	12,132	11,663	11,188	10,803

Table A-4

Model 1 - Predicting Acquirers in Mergers and Consolidations

Stepwise Logit Estimation of the Relationships Between Banks' Year-end Financial Condition and the Incidence of Mergers and Consolidations Over the Succeeding Two Years.

(FDIC-Assisted Mergers Not Classified as Mergers)

Estimated Coefficients (Standard Errors)

Explanatory

Variables	1985	1986	1987	1988	1989	1990	1991	1992	1993
Intercept	-10.4927	-8.6842	-8.4512	-8.2614	-8.7272	-8.9289	-9.1472	-9.3531	-8.4877
	(0.4298)	(0.5009)	(0.4077)	(0.4733)	(0.4273)	(0.3883)	(0.3567)	(0.3425)	(0.3916)
Interest-Bearing	--	--	--	-0.0080	--	--	--	--	-0.0119
Nonrisk Assets				(0.0035)					(0.0031)
Noninterest-Bearing	0.0515	0.0546	0.0977	0.0715	0.0838	0.0776	0.0485	0.0338	--
Nonrisk Assets	(0.0131)	(0.0110)	(0.0135)	(0.0138)	(0.0150)	(0.0137)	(0.0128)	(0.0153)	
Performing	0.0156	--	0.0081	--	0.0119	--	--	--	--
Risk Assets	(0.0040)		(0.0035)		(0.0038)				
Loan Portfolio	-0.0002	-0.0002	-0.0003	-0.0002	-0.0002	-0.0003	0.0003	-0.0002	-0.0003
Concentration (HHI)	(0.00006)	(0.00006)	(0.00005)	(0.00006)	(0.00005)	(0.00006)	(0.00005)	(0.00004)	(0.00005)
Total Loans Plus Securities	--	--	--	--	--	0.0076	--	--	--
with >= 5 yrs Maturity						(0.0038)			
Expense on Salaries	--	--	-0.4633	--	-0.3692	--	--	--	--
and Benefits			(0.1226)		(0.1100)				
Expense on Premises	--	0.4342	0.5809	--	--	--	--	--	--
and Fixed Assets		(0.1372)	(0.1961)						
All Other Noninterest	--	--	--	--	0.1761	0.1117	0.1114	0.1048	--
Expense					(0.0538)	(0.0447)	(0.0370)	(0.0373)	
Return on Earning	--	--	--	0.0798	--	--	--	--	--
Assets				(0.0365)					
Equity Capital	--	-8.5427	--	--	--	--	--	--	--
		(3.0338)							
Loan-Loss Allowance	--	0.1604	--	--	--	--	--	--	--
		(0.0761)							
Core Deposits	--	--	--	--	--	--	--	--	--
Core Deposit Growth	--	--	--	--	--	--	--	--	0.0016
									(0.0005)
Growth in Gross Loans	--	--	--	--	--	--	--	--	--
De Novo Bank Dummy	--	--	--	--	--	--	--	0.6053	--

						(0.2901)			
Supervisory Concern for Capital Dummy	-0.4026	-0.5235	--	--	--	-0.4078	--	--	--
	(0.1451)	(0.1438)				(0.1356)			
Supervisory Concern for Asset Quality Dummy	--	--	--	--	--	--	--	--	--
Supervisory Concern for Management Quality Dummy	--	--	-0.4088	-0.6075	-0.5297	--	-0.3587	-0.5921	-0.6023
			(0.1218)	(0.1414)	(0.1335)		(0.1153)	(0.1155)	(0.1426)
Supervisory Concern for Earnings Dummy	--	--	--	--	--	--	--	--	--
Supervisory Concern for Liquidity Dummy	--	0.3247	--	--	--	--	-0.4286	--	--
		(0.1436)					(0.1658)		
Log of Total Assets	0.5751	0.5028	0.4810	0.4853	0.4674	0.4877	0.5723	0.5900	0.6134
	(0.0311)	(0.0375)	(0.0302)	(0.0309)	(0.0320)	(0.0299)	(0.0275)	(0.0269)	(0.0276)
-2x Log of Likelihood	3623	4161	4070	3694	3677	3862	4001	4205	4220
Number of Observations	13,822	14,037	13,642	13,081	12,715	12,395	12,024	11,659	11,272
Pseudo R2	0.121	0.122	0.110	0.110	0.110	0.099	0.112	0.116	0.137
In-Sample at 10% Critical Probability Correct Predictions (%)									
Acquirers	26.8	32.0	26.7	25.8	26.9	26.6	32.5	36.2	41.2
Nonacquirers	96.1	94.6	95.0	95.6	95.3	95.3	94.0	92.8	90.7
Incorrect Predictions (%)									
False Acquirers or Type II Error	3.9	5.4	5.0	4.4	4.7	4.7	6.0	7.2	9.3
Missed Acquirers or Type I Error	73.2	68.0	73.3	74.2	73.1	73.4	67.5	63.8	58.8
Total Correct Predictions (%)	93.7	92.1	92.3	93.0	92.7	92.4	91.1	89.8	87.9
Number of Acquirers	473	565	544	485	487	515	557	605	636
Number of Nonacquirers	13,349	13,472	13,098	12,596	12,228	11,880	11,467	11,054	10,637

Table A-5

Model 1 - Predicting Acquirers in Non-affiliate Mergers

Stepwise Logit Estimation of the Relationships Between Banks' Year-end Financial Condition and the Incidence of Mergers Over the Succeeding Two Years.

Consolidations and FDIC-Assisted Mergers Not Classified as Mergers)

Estimated Coefficients (Standard Errors)

Explanatory Variables	1985	1986	1987	1988	1989	1990	1991	1992	1993
Intercept	-10.0735	-10.2933	-9.2250	-11.3179	-8.8894	-7.2415	-8.6121	-9.0727	-9.8373
	(0.5422)	(0.4662)	(0.4878)	(1.1054)	(0.5168)	(0.5461)	(0.4658)	(0.4149)	(0.4302)
Interest-Bearing Nonrisk Assets	--	--	--	--	--	--	--	--	--
Noninterest-Bearing Nonrisk Assets	--	0.0383	0.0518	--	0.0550	0.0533	0.0427	--	--
		(0.0158)	(0.0201)		(0.0223)	(0.0174)	(0.0154)		
Performing Risk Assets	--	--	--	--	--	--	--	--	--
Loan Portfolio Concentration (HHI)	-0.0002	--	--	-0.0002	--	-0.0003	-0.0002	-0.0001	-0.0002
	(0.00009)			(0.00009)		(0.00008)	(0.00007)	(0.00005)	(0.00005)
Total Loans plus Securities with >= 5 yrs Maturity	--	--	--	--	--	--	--	--	--
Expense on Salaries and Benefits	--	--	--	--	--	--	--	--	0.1650
									(0.0551)
Expense on Premises and Fixed Assets	0.4572	0.5837	--	--	--	--	--	--	--
	(0.1785)	(0.1576)							
All Other Noninterest Expense	--	--	--	--	--	--	--	--	--
Return on Earning Assets	--	--	0.0705	0.1588	--	--	--	--	--
			(0.0308)	(0.0357)					
Equity Capital	--	--	--	--	--	--	--	--	--
Loan-Loss Allowance	--	--	--	--	--	--	--	--	--
Core Deposits	--	--	--	0.0173	--	--	--	--	--
				(0.0067)					

Core Deposit Growth	--	--	--	--	--	--			0.0014
									(0.0005)
Growth in Gross Loans	--	--	--	--	--	--	--	--	--
De Novo Bank Dummy	--	--	--	--	--	--	1.0700	0.8955	--
							(0.3013)	(0.3235)	
Supervisory Concern for Capital Dummy	--	--	--	--	--	--	--	--	--
Supervisory Concern for Asset Quality Dummy	--	-0.4223	--	-0.5878	--	--	--	--	--
		(0.1578)		(0.2320)					
Supervisory Concern for Management Quality Dummy	-0.6379	--	-0.5009	--	--	--	-0.6182	-0.6504	-0.4867
	(0.2069)		(0.1991)				(0.1540)	(0.1549)	(0.1855)
Supervisory Concern for Earnings Dummy	--	--	--	--	--	--	--	--	--
Supervisory Concern for Liquidity Dummy	--	--	--	--	-0.7987	--	--	--	--
					(0.3140)				
Log of Total Assets	0.5637	0.5141	0.4249	0.5439	0.3890	0.3194	0.4764	0.5200	0.5730
	(0.0385)	(0.0382)	(0.0407)	(0.0563)	(0.0442)	(0.0420)	(0.0355)	(0.0325)	(0.0324)
-2x Log of Likelihood	2077	2237	2060	1777	1756	2094	2485	2798	2666
Number of Observations	13,822	14,037	13,642	13,081	12,715	12,395	12,024	11,659	11,272
Pseudo R2	0.093	0.079	0.058	0.074	0.045	0.030	0.076	0.081	0.106
In-Sample at 4% Critical Probability									
Correct Predictions (%)									
Acquirers	32.1	26.7	17.5	19.8	12.6	14.0	35.9	44.6	48.2
Nonacquirers	95.2	94.4	95.9	96.1	97.2	96.5	89.6	84.5	85.8
Incorrect Predictions (%)									
False Acquirers or Type II Error	4.8	5.6	4.1	3.9	2.8	3.5	10.4	15.5	14.2
Missed Acquirers or Type I Error	67.9	73.3	82.5	80.2	87.4	86.0	64.1	55.4	51.8
Total Correct Predictions (%)	94.1	93.3	94.7	95.1	96.1	95.1	88.3	83.3	84.7
Number of Acquirers	224	240	212	182	174	215	284	336	330
Number of Nonacquirers	13,598	13,797	13,430	12,899	12,541	12,180	11,740	11,323	10,943

TABLE A-6

Model 2. - Predicting Acquirers in Nonaffiliate Mergers

Stepwise logit estimation of the relationships between banks' year-end financial condition and the incidence of mergers over the succeeding two years.

(Consolidations & FDIC-Assisted Mergers not classified as Mergers)

Estimated Coefficients (Standard Errors)

Explanatory Variables	1985	1986	1987	1988	1989	1990	1991	1992	1993
Intercept	-10.6688	-10.3840	-9.5221	-11.7955	-8.7693	-7.2196	-8.7029	-9.2381	-9.9427
	(0.4507)	(0.4599)	(0.4739)	(1.0940)	(0.5154)	(0.5446)	(0.4657)	(0.4155)	(0.4316)
Interest-Bearing Nonrisk Assets	-	-	-	-	-	-	-	-	-
Noninterest-Bearing Nonrisk Assets	-	0.0352	0.0511	-	0.0588	0.0531	0.0407	-	-
		(0.0158)	(0.0202)		(0.0213)	(0.0174)	(0.0152)		
Performing Risk Assets	-	-	-	-	-	-	-	-	-
Loan Portfolio Concentration (HHI)	-	-	-	-0.0002	-	-0.0003	-0.0003	-0.0001	-0.0002
				(0.00009)		(0.00008)	(0.00007)	(0.00005)	(0.00006)
Total Loans plus Securities with >= 5 yrs maturity	-	-	-	-	-	-	-	-	-
Expense on Salaries and Benefits	-	-	-	-	-	-	-	-	-
Expense on Premises and Fixed Assets	-	0.5308	-	-	-	-	-	-	0.1566
		(0.1576)							(0.0571)
All Other Noninterest Expense	-	-	-	-	-	-	-	-	-
Return on Earning Assets	-	-	0.0803	0.1705	-	-	-	-	-
			(0.0294)	(0.0342)					

Equity Capital	-	-	-	-	-	-	-	-	-
Loan-Loss Allowance	-	-	-	-	-	-	-0.2316	0.2168	-
							(0.1053)	(0.1016)	
Core Deposits	-	-	-	0.0189	-	-	-	-	-
				(0.0067)					
Core Deposit Growth	-	-	-	-	-	-	-	-	0.0014
									(0.0005)
Growth in Gross Loans	-	-	-	-	-	-	-	-	-
De Novo Bank Dummy	-	-	-	-	-	-	1.0112	0.8820	-
							(0.3014)	(0.3232)	
Log of Total Assets	0.5868	0.5173	0.4412	0.5659	0.3713	0.3177	0.4942	0.5446	0.5787
	(0.0377)	(0.0378)	(0.0399)	(0.0556)	(0.0440)	(0.0419)	(0.0373)	(0.0345)	(0.0323)
2x Log of Likelihood	2097	2263	2068	1785	1785	2095	2498	2813	2674
Number of Observations	13,928	14,110	13,695	13,116	12,740	12,412	12,035	11,660	10,958
Pseudo R2	0.086	0.076	0.055	0.070	0.039	0.035	0.071	0.076	0.103
In-Sample at 4% Critical Probability									
Correct Predictions (%)									
Acquirers	29.9	28.1	16.5	19.2	11.4	14.0	35.2	42.0	45.8
Nonacquirers	95.6	94.7	96.1	96.3	97.3	96.6	90.4	85.3	86.1
Incorrect Predictions (%)									
False Acquirers or Type II Error	4.4	5.3	3.9	3.7	2.7	3.4	9.6	14.7	13.9
Missed Acquirers or Type I Error	70.1	71.9	83.5	80.8	88.6	86.0	64.8	58.0	54.2
Total Correct Predictions (%)	94.5	93.6	94.8	95.2	96.1	95.2	89.1	84.1	84.9
Number of Acquirers	224	242	212	182	176	215	284	336	330
Number of Nonacquirers	13,704	13,868	13,213	12,934	12,564	12,197	11,751	11,324	10,943

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Recent Developments Affecting Depository Institutions
by Benjamin B. Christopher and Valentine V. Craig

REGULATORY AGENCY ACTIONS
Inter-Agency Actions

The federal bank and thrift regulatory agencies are engaging in joint or coordinated efforts in a number of regulatory areas that are mentioned specifically in this issue of the Review. These joint initiatives concern capital adequacy for derivatives; interest-rate risk; retail sales of nondeposit investment products; "suspicious activity" reporting; and regulatory relief in storm-damaged areas.

Risk-Based Capital: Derivatives

The federal banking agencies the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board (FRB), and the Federal Deposit Insurance Corporation (FDIC) amended, effective October 1, 1995, risk-based capital standards for banks and bank holding companies to implement a revision to the Basle Accord. The Accord established a risk-based capital framework for assessing capital adequacy, implemented by the U. S. banking agencies in 1989. Under this framework, off-balance-sheet transactions were incorporated into the risk-based structure by converting each item into a credit-equivalent amount that was assigned to the appropriate credit-risk category according to the obligor or counterparty, or if relevant, the guarantor or the nature of the collateral. The credit-equivalent amount of an off-balance-sheet interest-rate or exchange-rate contract was determined by adding together the current replacement cost (current exposure) of the contract and an estimate of the possible increase in the future replacement cost (potential future exposure) in view of the volatility of the current exposure of the contract. The maximum risk category for rate contracts is 50 percent.

The effects of this final rule are: a) long-dated interest-rate and exchange-rate contracts are subject to higher conversion factors and new conversion factors are set forth that specifically apply to derivative contracts related to equities, precious metals, and other commodities; b) institutions are permitted to recognize a reduction in potential future credit exposure for transactions subject to qualifying bilateral netting arrangements; and c) derivative contracts related to equities, precious metals and other commodities may be recognized in bilateral netting arrangements for risk-based capital purposes. *FR, 9/5/95, p. 46170; FIL-59-95, FDIC, 9/8/95.*

Additionally, the Bank for International Settlements, in July 1996, released a draft proposal to require derivatives dealers worldwide to record the notional and replacement cost of all derivative contracts. Public comment is due by September 30, 1996, with reporting expected to begin on December 31, 1997. *AB, July 19, 1996.*

Capital Standards For Interest-Rate Risk

The OCC, the FRB, and the FDIC issued a final rule, effective September 1, 1995, implementing the FDICIA provision requiring banking agencies to revise risk-based capital standards to take adequate account of interest-rate risk. The final rule amended capital standards to specify that the banking agencies include in their evaluations of a bank's capital adequacy an assessment of the exposure to declines in the economic value of the bank's capital due to changes in interest rates.

Subsequently, in May 1996, the three regulatory agencies approved a scaled-back approach for considering bank interest-rate risk. The agencies adopted guidelines that advised bank directors to establish interest-rate-risk limits, to appoint officials to oversee policy, and to monitor management compliance. The agencies will continue to consider interest-rate risk when setting a bank's capital requirement, but agreed to examine each bank individually rather than apply a standardized interest-rate model across-the-board. The joint policy statement on interest-rate risk became effective on June 26, 1996. *FR, 8/2/95, pp. 39490, 39495; AB, 5/24/96; FR, 6/26/96, pp.33166; AB, 7/17/96.*

Retail Sales of Nondeposit Investment Products

The FDIC, the FRB, the OCC and the Office of Thrift Supervision (OTS) issued joint interpretations of their Inter-Agency Statement, released on February 15, 1994, on retail sales of mutual funds and other nondeposit investment products by federally insured financial institutions (see this Review, Winter 1995, p. 31). The interpretations give the inter-agency position regarding abbreviated disclosures and clarify instances where it is not necessary to provide disclosures.

There are limited situations in which the disclosure guidelines need not apply or where a shorter logo format may be used in radio broadcasts of 30 seconds or less, electronic signs, and other signs (such as banners and posters) used only as location indicators. Third-party vendors not affiliated with the depository institution need not make the Inter-Agency Statement disclosures on nondeposit investment product confirmations and in account statements that may incidentally, with a valid business purpose, contain the name of the depository institution. The interpretations state that with respect to shorter logo format disclosures that can be used in visual media, such as television broadcasts, ATM screens, and signs, the text of an acceptable logo format disclosure would include the statements "Not FDIC Insured," "No Bank Guarantee," and "May Lose Value," which would be boxed, set in bold face type, and displayed conspicuously. *FIL-61-95, FDIC, 9/13/95; with "Joint Interpretations of the Inter-Agency Statement," and response letter to the American Bankers Association, 9/12/95.*

On May 5, 1996, the FDIC issued the results of a nationwide survey it funded of approximately 1,200 FDIC-insured institutions to determine their compliance with inter-agency guidelines on the sale of uninsured investment products. The survey found that banks were more likely to make required disclosures in face-to-face discussions than over the phone. Required disclosures were also found to be made more frequently by investment personnel who were members of the National Association of Securities Dealers (NASD) or employed by third-party affiliates than by investment representatives affiliated with an internal banking group. *Survey of Nondeposit Investment Sales at FDIC-Insured Institutions,* *prepared by Market Trends, 5/5/96.*

Suspicious Activity Reports (SARs)

The Financial Crimes Enforcement Network (FinCEN) of the Department of the Treasury and the federal financial institutions' supervisory agencies issued new regulations requiring centralized filing with FinCEN of reports of suspicious transactions under the Bank Secrecy Act (BSA). A uniform "Suspicious Activity Report" (SAR) is to be used to report suspicious transactions and known or suspected criminal violations. Essentially the same rule was issued or is being issued by the five federal supervisory agencies for depository institutions.

The regulation raises the mandatory reporting thresholds for criminal offenses and reducing bank reporting burdens. For the reporting of known or suspected criminal activity when a bank has a substantial basis for identifying a non-insider suspect, the reporting threshold based on asset involvement is raised from the existing $1,000 to $5,000; where the bank has no substantial basis for identifying a suspect, the reporting threshold rises from the existing $5,000 to $25,000. Banks may file the referral form in several ways: they may submit an original form, a photocopy, or they may file by magnetic means, such as by computer disk. The regulatory agencies are also developing computer software to assist banks in preparing and filing the reports. *FR, 9/14/95, p. 47719; FIL-71-95, FDIC, 10/16/95; Comptroller of the Currency, News Release, OCC, NR96-12, 2/5/96.*

The designation of a single government recipient of all depository institution suspicious transaction reports is required under the Riegle Community Development and Regulatory Improvement Act of 1994. Previously, banks reported violations or suspected violations to their primary federal regulators and several law enforcement agencies using non-uniform criminal referral forms. They also filed currency transaction reports (CTRs) for transactions in currency of more than $10,000. *FR, 9/7/95, p. 46556; BBR, 9/11, p. 377; CEO Memo 53, OTS, 3/19/96.*

Record keeping For Funds Transfers

The FRB and the Department of the Treasury jointly proposed amendments to their rules requiring enhanced Record keeping on certain wire transfers by financial institutions in accordance with the Bank Secrecy Act. The proposed amendments were made to conform the meanings of the definitions of international funds transfer to the Uniform Commercial Code.

In January, the FRB and the Department of the Treasury adopted a final rule that required each domestic financial institution involved in a wire transfer to collect and retain certain information depending upon the type of financial institution, its role in the transfer, the amount of the transfer, and the relationship of the parties to the transaction. The rule exempted wire transfers below $3,000. The effective date was to have been January 1996, but postponements delayed the new Record keeping rules until May 1996.

FinCEN reports that electronic wire transfer systems move funds between financial institutions and handle a daily volume in excess of 500,000 transactions, moving more than $2 trillion around the world each day. Wire transfers have provided money launderers with an efficient and secure method of transferring huge sums of money over a very short period of time. Because wire transfer messages often are sent through several banks and wire transfer systems, launderers have been able to confuse the money trail and make it difficult for law enforcement to trace the criminal proceeds. *FR, 1/3/95, pp. 220, 231; 8/24, pp. 44144, 44146; Press Release, FRB, 12/22/94; 8/18/95; BBR, 8/28/94, p. 330; AB, 3/21/96.*

Bank Lending to Areas Subject to Floods

The OCC, the FRB, the FDIC, the OTS and the National Credit Union Administration (NCUA) are amending regulations regarding loans in areas having special flood hazards to implement the provisions of the National Flood Insurance Reform Act of 1994. Among the proposed amendments are new escrow requirements a lending institution that requires the escrow of taxes, property insurance premiums, fees or other charges must require the escrow of flood insurance premiums; explicit authority for lenders and servicers to "force-place" flood insurance under certain circumstances; and a requirement that lending institutions notify purchasers or lessees if the property securing the loan is located in a special flood hazard area (SFHA).

Additionally, the proposal requires each agency to assess compliance with the National Flood Insurance Program when examining the institutions it supervises, and to use a new standard form developed by the Federal Emergency Management Agency for recording whether a security property for a given loan is located in an SFHA. *FR, 10/18/95, p. 53962; PR-57-95, FDIC, 9/26/95.*

Federal Financial Institutions Examination Council Appraisal Regulation

The inter-agency Federal Financial Institutions Examination Council (FFIEC) is soliciting comment on how it should implement a section of Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, which was amended by the Riegle Community Development and Regulatory Improvement Act of 1994. The amendment added the requirements that: a) state appraiser certifying or licensing agencies are not to impose excessive fees or burdensome requirements for temporary practice; and b) the states are encouraged to develop reciprocity agreements that readily authorize appraisers who are licensed or certified in one state, and who are in good standing, to perform appraisals in other states. Since January 1, 1993, Title XI, as amended, has required all federally regulated financial institutions to use state-licensed or certified real-estate appraisers, as appropriate, to perform appraisals in federally related transactions. In response to the Title, each state, territory and the District of Columbia has established a regulatory program for certifying, licensing and supervising real-estate appraisers. *Press Release, Appraisal Subcommittee, FFIEC, 9/8/95; FR, 9/12, p. 47365.*

GAAP Approved For Call Reports

The FFIEC adopted the generally accepted accounting principles (GAAP) as the reporting basis for the balance sheet, income statement, and related schedules in the bank Reports of Condition and Income (Call Report), effective with the March 1997 report date. Adoption of GAAP as the reporting basis will eliminate existing differences between bank regulatory reporting standards and GAAP, among which are the accounting treatment of assets sold with recourse, futures, forwards, and option contracts. The reporting basis being adopted already is used for savings association Thrift Financial Reports and Federal Reserve bank holding company FR Y Reports, and is consistent with the objectives of Section 307 of the Riegle Community Development and Regulatory Improvement Act of 1994, which requires the federal banking agencies to develop a single form for the filing of core information by banks, savings associations, and bank holding companies.

The FFIEC believes that adopting GAAP will reduce reporting burden as well as any confusion on the part of users about differences in the reporting principles governing regulatory reports and financial statements. GAAP does not require the disclosure of all of the information needed by federal banking agencies and does not address all of the agencies' supervisory concerns, thus institutions would still have to report, in supplemental schedules and items, some information needed for supervisory and other purposes. The Council and the agencies will continue when necessary to issue specific reporting guidance that falls within the range of acceptable practice under GAAP (for example, as is currently the case for the allowance for loan and lease losses), and each agency will retain existing authority to require an institution to report a transaction in regulatory reports in accordance with the agency's interpretation of GAAP. *Press Release, FFIEC, 11/3/95.*

Mortgage Lending Reports

The FFIEC made available the reports of 1994 mortgage lending activity in metropolitan statistical areas (MSAs) for public inspection at a central depository in each MSA, and the agency headquarters. The reports, which are available almost two months earlier than last year, include individual disclosure statements and aggregate data for each MSA. They reflect the lending activity of the more than 9,800 lending institutions covered by the Home Mortgage Disclosure Act (HMDA) that reported data for 1994 to member agencies of the FFIEC and to the Department of Housing and Urban Development. The reports contain data about loan originations, loan purchases, and applications that did not result in a loan. Also, they give information about the race or national origin, gender, and annual income of the applicants or borrowers. For most loans relating to property located in MSAs, the reports identify the geographic location, usually by Census tract.

Data from the HMDA reports released in July indicated that the number of conventional home purchase loans went up 54.7 percent for blacks and 42.0 percent for Hispanics since 1993. *Press Release, FFIEC, 9/1/95.*

Proposed Revisions to CAMEL Rating System

The FFIEC proposed revisions to its Uniform Financial Institutions Rating System (commonly referred to as the CAMEL rating system) on July 9, 1996. Comments are due by September 16, 1996. The proposed changes include clarifying the component rating descriptions; addition of a sixth component to address market risk; and increased emphasis on risk management. *FIL-56-96; 7/24/96; FR, 7/18/96; p. 37472.*

Risks to Computer Systems in the New Millenium

The FFIEC issued a statement on July 12, 1996, alerting financial institutions to the need to address risks involving their computer systems as the industry enters the new century. Examiners will review each institution's 2000 plan during regular supervisory reviews. The risks arise from the programming code in existing computer systems that may cause the system to function improperly due to the two digit year field containing "00." *FIL-50-96, 7/12/96.*

Federal Deposit Insurance Corporation Assessments

The FDIC Board of Directors voted on August 8, 1995, to reduce significantly the deposit insurance premiums paid by most banks but to keep existing assessment rates intact for savings associations. Under the new rate structure, the best-rated institutions insured by the Bank Insurance Fund (BIF) would pay four cents per $100 of domestic deposits, down from 23 cents per $100. The weakest institutions would continue to pay 31 cents per $100. The FDIC announced in September 1995, that the BIF was fully recapitalized and that it would refund to banks insurance overpayments for the period of June through September. The FDIC estimated the aggregate BIF assessment refund at $1.49 billion, plus $19.9 million in interest. *PR-50-95, FDIC, 8/89/95; PR-54, 9/5.*

On September 26 1995, the FDIC amended its regulation on assessments to delay the regular payment date for the first quarterly payment for the first semiannual period from December 30 of the prior year to January 2 (or the first business day thereafter). At the same time, insured institutions were given the option of making the first payment on December 30 (or the prior business day). The FDIC's purpose in making these changes was to relieve certain institutions of the regulatory burden of having to make an extra assessment payment in 1995, while also affording flexibility to other institutions to make such a payment if they so desired.

The amendments approved in late September 1995, also give insured institutions the option of paying double the amount of any quarterly payment, when the payment is made on a payment date (regular or alternate) that comes before the start of the quarter to which the payment pertains on the March, June, September, and December payment dates.

The interest rate to be applied to under payments and overpayments of assessments is replaced with a new, more sensitive rate derived from the 3-month Treasury bill discount rate. Rates set under the prior standard have rapidly become obsolete in volatile interest-rate markets.

The timetable for announcing the semiannual assessment rate schedule is shortened from 45 days to 15 days prior to the invoice date. This change enables the FDIC to use the most up-to-date information available for computing assessments, thereby benefitting both the agency and the depository institutions. The rule is effective September 29, 1995, except some amendments are effective October 30, 1995. *FR, 9/29/95, p. 50400; 8/10, p. 40776; FIL-67-95, FDIC, 10/6/95.*

The FDIC Board of Directors voted on May 14, 1996, to maintain the existing assessment rates on deposits by the BIF and the SAIF for the second semiannual assessment period of 1996. Insured institutions will continue to pay annual assessment rates of from zero to $.27 per $100 of BIF-assessable deposits, subject to a quarterly minimum of $500. Based upon year-end 1995 data, it is expected that these rates will result in an average annual BIF rate of approximately $.0029 per $100 of deposits and annual revenues of about $72 million. The BIF reserve ratio was 1.30 percent as of December 31, 1995.

Institutions insured by the Savings Association Insurance Fund (SAIF) will continue paying premiums on a risk-related basis of between $.23 per $100 to $.31 per $100 of assessable deposits. It is expected that these rates will result in an average annual SAIF rate of approximately $.234 per $100 in assessable deposits. SAIF-insured institutions will continue to pay higher rates than BIF-insured banks because the SAIF remains seriously undercapitalized. At December 31, 1995, the SAIF had reserves of approximately $3.4 billion and is not expected to reach the minimum reserve level of 1.25 percent until the year 2002, given the current circumstances and reasonably optimistic assumptions. *PR-70-95, FDIC, 11/14/95; FIL-40-96, 6/11/96.*

Thrifts Allowed to Transfer Deposits to Affiliates

The FDIC has decided that thrifts may transfer deposits to newly chartered bank affiliates, if the deposit shift is initiated by the depositor. This decision will allow thrifts to take advantage of cheaper deposit insurance available to banks. The FDIC ruling is expected to accelerate the outflow of funds from the thrift industry, thereby reducing the FICO payment base. *WSJ, 7/3/96.*

Assessments For Oakar Institutions

On July 3, 1996, the FDIC proposed to amend its assessment regulations regarding the so-called Oakar institutions institutions that belong to one insurance fund, but hold deposits that are treated as insured by another insurance fund. The changes would affect particularly calculations of the Adjusted Attributable Deposit Amount (AADA). The AADA is used to determine the allocation of an Oakar institution's deposits between the BIF and the SAIF.

The proposed amendments are intended to eliminate anomalies in the assessment of these institutions' deposits. One amendment would change the AADA adjustment for an institution's overall deposit growth. The FDIC has found that the current treatment of deposit sales for Oakar institutions has resulted in an increase in the total amount of primary fund deposits reported and assessed and a decrease in the total amount of secondary fund deposits reported. The proposed rule would correct this anomaly for all deposit sale transactions occurring after June 30, 1996; and would adjust the AADA for growth or shrinkage on a quarterly basis. The FDIC is also proposing to eliminate the requirement that Oakar institutions submit growth worksheets to adjust the AADAs. Finally, public comment is requested on two options for allocating funds to the BIF or the SAIF at the time of deposit sales. One option would treat deposit sales by Oakar institutions as sales of primary fund deposits only (unless the deposits sold exceeded the amount of primary fund deposits available); the second alternative would treat the deposits as a pro rata blend of the institutions' primary and secondary fund deposits. *FIL-54-96, 7/19/96; FR,3/3/96, p. 34751.*

BIF and SAIF First-Quarter 1996 Financial Highlights

The BIF earned $295 million in net income in the first quarter of 1996, significantly below the $1.3 billion earned the same period a year earlier. The decrease is primarily due to the reduction in premium rates. The fund's estimated liability for anticipated failures decreased to $240 million from $279 million at year-end 1995. The fund balance at the end of the quarter was $25.748 billion. One BIF-insured bank failed during the quarter. The SAIF earned $292 million in net income in the first quarter of 1996, $13 million more than it earned in the same quarter a year earlier. Net assessment revenue came to $251 million through the first quarter of

1996 after payments of $393 million to service Financing Corporation (FICO) obligations. The fund balance at the end of the quarter rose to $3.650 billion. *Federal Deposit Insurance Corporation, First-Quarter 1996 Financial Results, Bank Insurance Fund, 3/31/96.*

Capital Maintenance

The FDIC adopted an interim rule and requested comments to implement Section 208 of the Riegle Community Development and Regulatory Improvement Act of 1994 which provides that a qualifying insured depository institution that transfers small-business loans and leases on personal property with recourse need include only the amount of retained recourse in its risk-weighted assets when calculating its capital ratios if certain conditions are met. The transaction must be treated as a sale under GAAP; and the transferring institution must establish a non-capital reserve sufficient to meet the reasonably estimated liability under the recourse arrangements. A qualifying institution is one that is well-capitalized or, with the approval of the appropriate federal banking agency, adequately capitalized. For these institutions, the rule, which is effective August 31, 1995, will result in lower capital requirements for affected loans and leases. *PR-52-95, FDIC, 8/25/95; FR, 8/31, p. 45606; p. 45612 (FRB notice); p. 45618 (OTS notice).*

Final Rules on Golden Parachutes, Internal Audits and Foreign Bank Deposits

The FDIC issued a final rule, effective April 1, 1996, prohibiting with certain exceptions golden parachute payments to executives of troubled holding companies, banks and thrifts. Exceptions to the prohibition include payments to qualified pension and retirement plans. The rule provides guidance on what constitutes legitimate payments. The new rule also limits holding companies or FDIC-insured institutions from paying the legal expenses or liabilities of their employees or directors who are subject to enforcement proceedings. *PR-8-96, FDIC, 2/6/96; BBR, 2/12/96, pp. 205-206.*

Court Supports Agency on Cross-Guaranty

The U.S. Court of Appeals for the Second Circuit upheld the FDIC's power, granted to the agency by FIRREA in 1989, to charge losses from a bank failure to another bank in the same corporate organization (Meriden Trust and Safe Deposit Co. v. FDIC). It rejected claims that such action amounts to an unconstitutional taking under the Fifth Amendment. In 1994, a federal claims court judge held that the agency's use of the cross-guaranty power might be a violation of the takings clause (Branch v. U.S.). *BBR, 8/14/95, p. 308.*

On July 24, 1996, First Coastal Corporation of Westbrook, Maine, paid the FDIC $9.75 million to settle a cross-guaranty assessment levied against its subsidiary, Coastal Savings Bank of Portland, Maine, in 1993. *FDIC, PR-55-96. 7/24/96.*

Court Rules Government Breached Contracts With Savings-and-Loan Associations

On July 1, 1996, the U. S. Supreme Court ruled in the United States v. Winstar Corp., No 95-865, that Congress erred in changing industry accounting rules concerning supervisory goodwill in 1989. The plaintiffs were Glendale Federal Bank of California, and two since-closed thrift companies, Statesman Savings

Holding Corporation and Winstar Corporation, who acquired weak savings institutions at the government's behest in the 1980s and in return were given assurances that the supervisory goodwill created in the transactions could be counted as capital and written off over time. The regulators subsequently refused to honor the agreements that they claimed were repudiated under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

The Federal Circuit Court of Appeals had previously ruled that the government violated contracts with the three plaintiffs. In this most recent ruling, the U.S. Supreme Court concluded that "it would have been madness" for the institutions to have taken over the weak institutions if they had known that the government could cancel the current accounting "gimmicks" at its will. The Court ruled that the government was liable for damages, and sent the case back to a lower court to determine those amounts. Breach-of-contract suits have been filed by at least one hundred thrifts. *BBR, 9/11/95, p. 403; AB, 8/31, p. 1, AB, 7/26/96, WSJ, 7/2/96, NYT, 7/2/96.*

Subsequent to the Supreme Court ruling, the FDIC took steps to appear as plaintiff in two cases involving supervisory goodwill pending in the U.S. Court of Federal Claims, and is investigating other cases with possible goodwill claims to determine whether it will become a plaintiff. In these cases, the FDIC is acting as a receiver for the failed institutions. *FDIC, PR-56-96, 7/24/96, AB, 7/26/96.*

D'Oench Duhme Doctrine Rulings

The U.S. Court of Appeals for the District of Columbia ruled in August 1995, that the FDIC might use the D'Oench Duhme doctrine to void secret agreements that would cause a loss in a failed bank's assets, but could not use it as a protection against fraud claims. In this case, an investor in a bankrupt Florida resort sued the developers and Southeastern Bank, charging that the bank secretly controlled the development and was responsible for fraudulent statements about the project's financial condition.

In another recent case, the U. S. Court of Appeals for Atlanta found that Congress did not eliminate the D'Oench Duhme doctrine in passing the thrift bailout law in 1989. In this case, the 11th Circuit Court concurred with a May 1996, FDIC ruling that the D'Oench Duhme doctrine prevented a car dealership from suing for breach of contract against Southeast Bank of Florida.

The D'Oench Duhme doctrine began with a 1942 Supreme Court decision and legislation enacted in 1950. It required that the FDIC recognize only written agreements by banks that subsequently fail and was intended to force bankers to put agreements in writing so that examiners could more accurately evaluate an institution's financial condition. *AB, 8/9/95, p. 2; 5/31/96, p. 2.*

Court Rules Examination Reports Accessible During Discovery

The U.S. Court of Appeals for the Sixth Circuit, rejecting an attempt by Bankers Trust Company to shield its examination results, ruled that parties to a lawsuit can seek examination reports from banks during the discovery process. As a result of the decision, which affects banks in Ohio, Michigan, Kentucky and Tennessee, a litigant can ask the bank for a report directly, and if refused can ask the trial judge to order the bank to comply. The judge must first give the regulator a chance to object. Previously, a litigant's request for an examination report had to be made through the bank's regulator, and if refused, which usually occurred in respect to the examiner's subjective comments, the plaintiff could seek compliance through the court. *AB, 8/10/95, p. 3.*

Improvement in Real-Estate Markets Reported

The FDIC's July 1996 Survey of Real Estate Trends reported continued improvements in both commercial and residential real-estate markets during the second quarter of 1996. The latest results represented the second consecutive quarter of reported improvements and were the most positive in over a year.

The quarterly survey asks field personnel from all federal bank and thrift regulatory agencies about developments during the prior three months in their local real-estate markets. The survey reflected positive trends in market activity in many areas of the nation, with the Northeast and the West reporting the most gains. The proportion of respondents seeing better market conditions in the South and the Midwest remained the same or declined following reports in April of significant progress.

The national composite index, summarizing assessments of real-estate markets, edged up to 68 in July from 67 in April. Values above 50 indicate that more examiners and asset managers at federal bank and thrift regulatory agencies thought conditions were improving than declining. The July report represents the second consecutive increase in the summary index from its recent low of 60 in January. Although the gains reported in the last three months were not as strong as those observed in the February-April period, the July composite index is the highest reading in two years.

Survey respondents reported continued confidence in the residential markets. Forty-five percent observed better conditions in their local housing markets the same proportion reported previously. However, those noting worsening conditions in July fell to eight percent. The national summary index for residential markets inched up to 69 from 68 in April, with a substantial boost from gains in the West, where 66 percent of the respondents reported better housing conditions, up from 54 in April.

Overall assessments of commercial real-estate trends continued to be positive as well. An increasing proportion of survey participants observed improving conditions (38 percent) while reports of worsening conditions were very few (one percent). As a result, the composite index for commercial markets rose to 68 in July from 66 in April. *Survey of Real Estate Trends, July 1996.*

Online Press Release Service Via Internet

The FDIC has established an online subscription service that allows subscribers to receive over the Internet and World Wide Web press releases and copies of key Congressional testimony and major speeches by agency officials. The new service will send the material directly to subscribers via e-mail. Released materials will continue to be available via fax modem, postal service mail and from information racks in FDIC buildings. *PR-59-95, FDIC, 10/4.*

Disclosure of Information

The FDIC revised the procedures used by the public in requesting records under the Freedom of Information Act (FOIA) and the Freedom of Information Reform Act (FOIRA). Among its provisions, the final rule sets forth the conditions under which exempt records may be disclosed to third parties, including such conditions as are necessary to protect the confidentiality of the records. The rule contains procedures by which the agency would charge appropriate fees as required under FOIRA and guidelines established by the Office of Management and Budget. The FOIRA significantly amended the fee provisions of FOIA by establishing classes of FOIA requesters and a framework under which fees could be charged to the individual categories of requesters. *FR, 7/6/95, p. 35148; 11/30, p. 61465.*

New FDIC Board Member

Former Mississippi Banking Commissioner Joseph H. Neely was sworn in as a member of the five-person FDIC Board on January 29, 1996. As Mississippi's Banking Commissioner, a position he occupied since 1992, Mr. Neely served as the primary regulator and supervisor of state-chartered banking and thrift institutions. He was also responsible for supervising state-chartered credit unions and consumer finance companies. Additionally, Mr. Neely served on the faculty of the Mississippi School of Banking from 1993 to 1995. *PR-6-96, FDIC, 1/29/96.*

Stored-Value Cards

On July 16, 1996, the FDIC issued an opinion on whether federal deposit insurance applied to stored-value cards. Stored-value cards look like a credit card or ATM card and store electronic value on either a magnetic stripe or a computer chip, and can be used to pay for purchases. The FDIC concluded that in most cases stored-value cards are not protected by deposit insurance. However, if the funds represented by the card were maintained in the customer's own account, rather than a single pool, deposit insurance would apply. The FDIC scheduled a hearing for September 12, 1996, on stored-value cards, Internet banking and other electronic payment systems. *FDIC PR-52-96, 7/16/96; PR-53-96, 7/16/96.*

FDIC Review of Regulations

The FDIC is conducting a systematic review of its regulations and policies to identify and revise regulations that might be inefficient, cause unnecessary burden, or contain outmoded, duplicative or inconsistent provisions. In one action, the FDIC issued an inter-agency proposal to remove inconsistencies in the way regulators assign risk-based capital requirements to certain loans and other collateralized transactions. The agency also proposed that publicly traded FDIC-supervised banks use Securities and Exchange Commission (SEC) rules for registration of securities and reporting instead of separate but similar FDIC rules. Final action was also taken eliminating outmoded policies on the submission of quarterly Reports of Condition and Income and the advertising of Negotiable Order of Withdrawal (NOW) accounts. *FDIC, PR-44-96, 6/17/96; FIL-48-96, 7/12/96; FR, 7/3/96, p. 34814.*

Resolution Trust Corporation Thrift Depositor Protection Oversight Board Will Continue

The Thrift Depositor Protection Oversight Board (TDPOB) continues in operation following termination of the Resolution Trust Corporation (RTC) on December 31,

1995. It is responsible for preparing final reports on the resolution of the thrift crisis and for overseeing the Resolution Funding Corporation, which between 1989 and 1991 issued long-term bonds to finance the resolution. The Board's membership will be reduced to three the Secretary of the Treasury, Chairman of the Federal Reserve Board, and Secretary of the Department of Housing and Urban Development. *AB, 12/6/95, p. 2.*

Last RTC Auction

At its eighth and final national auction, the RTC sold performing and nonperforming loans with a book value of $577 million. It recovered $404 million on the sale, approximately 70 percent of book value. The three-day auction was held in Kansas City beginning December 13, 1995. *National Mortgage News, 1/2/96, pg. 3.*

Final Cost of Thrift Bailout

The GAO reported that the thrift cleanup cost the taxpayer $160.1 billion in direct costs or $480.9 billion, if interest costs are included. Direct costs consist of $87.9 billion spent by the RTC; $64.7 billion spent by the FSLIC; and $7.5 billion in tax breaks to acquirers of ailing institutions. Interest costs consist of $111.8 billion of interest expenses on two bond issues, and $209 billion in interest computed on Congressional appropriations. Interest costs are not generally counted in government allocations. *The New York Times. 7/13/96; WSJ, 7/15/96; The Washington Post, 7/13/96.*

Federal Reserve Board Derivatives Transaction Standards

The Federal Reserve Bank of New York and five securities industry groups released final transaction standards for derivatives market participants. The standards cover such issues as the definition of a participant, a client's reliance on a dealer's advice, confidentiality, valuation, distribution of the standards, information, and disputes, but do not include any provision for dealers to determine a client's suitability for a particular transaction. *BBR, 8/28/95, p. 329.*

International Operations of Banks

The FRB proposed to amend its Regulation K to provide additional general consent authority for de novo investments in foreign countries by U.S. banking organizations that are strongly capitalized and well-managed. Banks meeting these requirements would be permitted to make certain investments without the need for prior approval or review. In order to strike a reasonable balance between reduced regulatory burden and continued FRB oversight, limits would be imposed on the total amount of general consent investments that may be made in a year. In addition, certain investments or activities would not be eligible for the expanded authority. Investors making use of the expanded authority would be required to provide the FRB with a post-investment notice. The Board's proposal is part of an overall review of the regulation. *FR, 9/25/95, p. 49350; Press Release, FRB, 9/22.*

Proposed Amendments to Leasing Regulation

The FRB proposed amendments to its Regulation M, implementing the Consumer Leasing Act, which was enacted into law in 1976 as an amendment to the Truth in

Lending Act (TILA). Generally, the CLA applies to consumer leases of personal property such as automobiles and furniture involving $25,000 or less, and a term of more than four months. Among the disclosures required of lessors are the amount of the initial charges to be paid, a payment schedule, the responsibilities for maintaining the leased property, and the liability for terminating a lease early. Among the proposed amendments are: additional disclosure requirements about early termination charges; disclosure of the gross costs of leases, the residual value, and the estimated lease charge; and, pursuant to a statutory change, new advertising provisions for radio and television.

The Board also proposed changes to the official staff commentary on Regulation M. *Press Release, FRB, 9/13/95; FR, 9/20, pp. 48752, 48769; BBR, 9/18, p. 438.*

Investment Advisory Powers Expanded

The FRB granted authority for Credit Suisse of Zurich to provide discretionary portfolio management services for futures and options on nonfinancial commodities. The service, to be provided through a New York-based subsidiary, will be limited to institutional customers who specifically request it. The FRB said the approved activity is similar to other investment advisory services that bank holding company affiliates provide. *AB, 7/7/95, p.2.*

Banks Permitted to Purchase Education Finance Firm

The FRB granted approval for four North Carolina-based bank holding companies to purchase the shares of a company that will provide services to North Carolina and other state governments in programs to assist parents in financing higher education for their children. Among the firm's activities will be developing and managing an education savings and loan plan, designing and providing software, providing marketing materials, and training state employees. *BBR, 10/2/95, p. 532.*

Changes in Fedwire Access Policy

The FRB has modified its Fedwire third-party access policy to clarify its applicability and to reduce the administrative burden of several provisions. Some depository institutions have entered into arrangements under which a third party provides operating facilities for their Fedwire services; under such arrangements, the third party's actions may result in a debit to the institution's reserve or clearing account at a Federal Reserve Bank. The policy provides important safeguards to both depository institutions participating in third-party access arrangements and to the Reserve Banks. Among other things, the policy requires depository institutions to impose prudent controls over Fedwire funds transfers and book-entry securities transfers initiated, received, or otherwise processed on their behalf by a third-party service provider. These policy modifications are on an interim basis pending the completion of a broader review of supervisory policies that should be applicable to outsourcing arrangements. The changes become effective August 10, 1995; existing Fedwire third-party arrangements should be in compliance by March 1, 1996. *Press Release, FRB, 8/10/95.*

Access to Automated Clearing House Service

The FRB is requesting comment on the benefits and costs of adopting a policy to control access to the Federal Reserve Banks' automated clearing house (ACH) service by entities other than the depository institution whose Federal Reserve account will be debited. The controls would apply to ACH credit transactions sent by third-party processors (service providers) and respondent depository institutions directly to a Reserve Bank or a private ACH operator that exchanges transactions with a Federal Reserve Bank. Controlling access to the ACH service will help to ensure the safety and soundness of the ACH system.

The FRB is requesting comment on the specific provisions of the proposed policy and the cost and operational impact of providing risk-monitoring capabilities for controlling access to the Federal Reserve Banks' ACH service. The risk-monitoring capabilities are intended to permit the depository institutions that are responsible for funding ACH credit transactions to control the potential credit risk and reduce the risk of fraud created by their customers and respondent depository institutions. The proposed policy provisions and monitoring alternatives do not cover ACH debit transactions. *Press Release, FRB, 8/10/95; FR, 8/15, p. 42413.*

Survey of Consumer Finances

The FRB is sponsoring a statistical study of household finances that will provide information on the economic condition of a broad array of American families. The study, which is undertaken every three years, is being conducted by the National Opinion Research Center at the University of Chicago through November 1995. Participants in the study are chosen at random using a scientific sampling procedure in 100 areas across the U.S. Participation is voluntary. Summary results will be published in the Federal Reserve Bulletin. *Press Release, FRB, 8/7/95.*

Mortgage Loan Software Program

The FRB announced the availability, free of charge, to member banks of a computer software program designed to serve as an analytic tool for financial institutions in offering affordable mortgage loans to low- and moderate-income applicants. The software program, entitled "Partners" can determine within seconds if potential home buyers can qualify, mathematically, for a home purchase loan, given the underwriting criteria and financial information provided. In addition to determining loan eligibility, "Partners" offers loan amortization schedules, equity build-up calculations, and secondary market analysis. The program also can be utilized by community groups, government agencies, and other community development practitioners who offer home purchase loans. *Press Release, FRB, 10/19/95.*

Regulatory Review Timetable

The FRB published a schedule for review of its major regulations, policy statements, and regulatory guidances as required under Section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994. Section 303 requires that each federal banking agency review its regulations and written policies to accomplish certain goals. These goals are to streamline and modify regulations and policies to improve efficiency, reduce unnecessary costs, and eliminate unwarranted constraints on credit availability; to remove inconsistencies and outmoded and duplicative requirements; and to work jointly with the other federal banking agencies to make uniform all regulations and guidelines implementing common statutory or supervisory policies.

The FRB noted that it has undertaken over 20 separate measures since the passage of Section 303 to reduce the burden and simplify regulations, written policies and procedures. Additionally, several proposals were out for comment which will further these efforts. *FR, 10/16/95, p. 53546.*

Federal Reserve Board Appointments

President Clinton reappointed Federal Reserve Chairman Alan Greenspan to his third four-year term as Federal Reserve Board Chairman. White House Budget Director Alice M. Rivlin and Washington University professor Laurence H. Meyer were also nominated to fill the two remaining vacancies on the Board. John P. LaWare left the Board in April of 1995 and Alan Blinder in January of this year. All three individuals are economists. *BBR, 2/26/96, p. 291; AB, 2/26/96, p 1-2.*

Office of the Comptroller of the Currency "Supervision by Risk" Program

The OCC is expanding, enhancing and standardizing the way examiners evaluate risk in national banks. The agency has defined nine specific categories of risk it will use in assessing risks in bank activities. The program focuses on evaluating the quantity of risk exposure in an institution and determining the quality of the risk-management systems in place to control that risk. The nine definitions, among which are credit risk, interest-rate risk, liquidity risk, and price risk, will enable the agency to treat the same risks consistently in all banks and across various products and activities, and they clarify for bankers the kinds of risk the OCC will be assessing in their institutions. Risk profiles prepared for each bank will help focus examiner attention on the most serious concerns within a bank and direct the agency's resources to institutions where the need is greatest. *News Release, OCC, 9/26/95.*

Examiner Guidance on Establishing Reserves

The OCC released a new Comptroller's Handbook section "Allowance For Loan and Lease Losses" (ALLL). This new section replaces the ALLL examination section that has been in effect since 1992. It requires no changes in basic examination objectives and procedures but consolidates a number of ALLL-related materials and identifies specific categories of risk. *NR 96-75, OCC, 6/19/96.*

Bank Examiner Guidance on Futures Brokerage

The OCC issued to its examiners guidance on derivatives that is applicable to subsidiaries that operate as futures commission merchants (FCM) registered with the Commodity Futures Trading Commission. Among the several elements of the guidance are: a) FCMs are expected to have a risk control unit that is separate from the unit that trades in derivatives futures; b) the independent risk control unit is to report to executive management, the bank's board of directors or a designated management committee, and is to communicate findings periodically to senior management and the bank's board; and c) capital to support risk exposures of the futures brokerage subsidiary should reflect the level and complexity of the risk and not be limited to meeting regulatory requirements. An FCM's compliance program should include at least one designated compliance officer, and include also standards for disclosure of risk to customers, and a plan for ethics training for FCM employees. *News Release, OCC, 11/9/95.*

Disclosure of Fair-Lending Self-Assessments

The OCC issued interim policy guidelines on banks' disclosure of the results of fair-lending self-assessments, identifying two types of self-assessments that national banks will not be routinely required to report to the agency. The two types of assessments are 1) where a bank uses "testers" or "mystery shoppers" to pose as loan applicants ("self test"); and 2) where the bank reviews actual loan files or related information, internal policies and procedures, training materials or audit reports and makes assessments based on information about actual loan applicants ("self evaluation"). The OCC will generally not take enforcement action against a national bank that discovers a fair-lending violation through self-assessment, when the bank takes appropriate, timely and complete corrective action in response. OCC examiners will not require or request any information about a bank's self- assessments, unless the agency has independently determined that the bank has unlawfully discriminated and is using the results of the self tests to defend itself.

Although the OCC will not take enforcement action in the situations outlined above, the agency will make referrals to the Department of Justice or notify the Department of Housing and Urban Development as required by statute or executive order. *News Release, OCC, 9/28/95.*

Risk-Based Capital Model

The OCC sent to all national banks a revised risk-based capital (RBC) planning model that can assist bank management in the calculation of, and planning for, supervisory capital. The revised model augments the previous version by highlighting the calculation of a bank's legal lending limit. The OCC notes that since the initial shift to the RBC framework in 1989, the supervisory role of the RBC has increased considerably. For example, the RBC ratio is a principal trigger under prompt corrective action for regulatory intervention into a bank's activities. It also is one of the two variables used in the FDIC's approach to deposit insurance premiums. In addition, the ratio is a component of other supervisory policies and statutory requirements, such as those relating to interbank liabilities, pass-through insurance, and brokered deposits. *Bul. 95-62, OCC, 11/16/95.*

Small Banks' Compliance Examinations

The OCC issued new streamlined examination procedures for assessing small banks' compliance with fair-lending laws, the Home Mortgage Disclosure Act, and a number of other banking-related consumer protection laws. The new procedures, effective January 1, 1996, apply to all community banks with total assets of less than $250 million and no regional or multinational affiliation, and under certain circumstances, may be used in banks with total assets of up to $1 billion. *News Release, OCC, 9/18/95.*

Income From Sales of Credit Life Insurance

The OCC proposed to revise its regulation governing credit life insurance to eliminate unnecessarily detailed provisions, reorganize sections of the rule, and refocus the regulation to areas of greatest safety-and-soundness concerns. The rule would provide that directors, officers, employees, and shareholders owning five percent or more of the bank's stock are not allowed to retain commissions or otherwise profit from the sale of credit life insurance to the bank's customers. Also, it would state for the first time that bank officials and insiders who sell credit life for personal profit are engaging in an unsafe and unsound banking practice. Banks would not be permitted to structure incentive or bonus programs in a way that creates incentives for bank officials to make inappropriate recommendations or sales to bank customers. Among other issues is whether dual employees who work for a bank and a non-bank company should be treated like bank employees, subject to the same limitations on bonuses and incentive arrangements, when they sell credit life insurance to bank customers. *FR, 9/13/95, p. 47498; AB, 9/14, p. 4; News Release, OCC, 9/13/95.*

Lease Financing Transactions

The OCC proposed to revise its regulation governing the personal property lease financing transactions of national banks, under the agency's Regulation Review Program. Comments are requested on allowing banks to rely more on the residual value of leased property, and less on the creditworthiness of the lessor, in deciding whether to enter into a lease. Another issue is the time period that banks have to dispose of property after the lease expires. *FR, 9/6/95, p. 46246; News Release, OCC, 9/6; AB, 9/6, p. 2.*

Profits From Community Development Investments

The OCC finalized a rule allowing national banks to keep profits from community development corporation and project investments. Previously, banks were required to reinvest dividends and other distributions received from community development investments into other activities that promoted the public welfare. The OCC found that this provision effectively discouraged investments in these types of projects. *AB, 2/1/96. FR, 10/26/95, p. 54819.*

Lending Bias Charges Settled

The U.S. Justice Department has gained settlements involving, for the first time, charges of bias in a bank's overage practices, and lending discrimination against Hispanics. Huntington Mortgage Co., a subsidiary of Huntington Bancshares Inc., agreed to pay $420,000 to settle charges that the company imposed higher up-front fees (overages) on loans to black borrowers than it charged other borrowers in the Cleveland area. Huntington denied past wrong-doing, but agreed to continue to limit its overages to one percent of the loan amount, and also it will make available all loan applications to Justice annually for the next three years. Security State Bank, Pecos, Texas, agreed to pay $510,000 in damages and penalties to resolve charges that a loan officer charged Hispanic borrowers higher interest rates on consumer loans than white customers paid. Security State said the officer involved in the charges has since left the bank, and that it does not discriminate in lending activities. The referral to Justice in the Huntington case resulted from an OCC fair-lending examination in 1993; in the Security State case the referral was made by the FRB from an examination by the Federal Reserve Bank of Dallas. *AB, 10/19/95, p. 2.*

Supreme Court Upholds Expanded Bank Insurance Powers

The U.S. Supreme Court ruled unanimously on March 26 in Barnett Bank of Marion County, N.A. v. Nelson (USSupCt No. 94-1837) that states must allow nationally-chartered banks to sell insurance as permitted under federal law. In a ruling on a case brought by Barnett Banks of Jacksonville against the state of Florida, the justices ruled that Section 92 of the 1916 National Bank Act, which allows banks in communities with less than 5,000 persons to sell insurance, preempted a Florida statute barring bank insurance activity. The ruling effectively voids bank insurance restrictions in 15 states.

This Supreme Court decision upholds the 1986 interpretation by the OCC that Section 92 of the National Bank Act authorized banks to sell insurance through branches located in small towns. Since it issued that interpretation, about 200 national banks have begun selling insurance. While the ruling only applies to nationally chartered banks, most states grant state-chartered banks the same powers as national banks.

The justices did not decide who will regulate bank insurance sales the OCC or state officials. Currently, legislation is pending in the House that would require state regulation of bank insurance sales and would prohibit the OCC from expanding bank insurance powers for five years.

Subsequent to the Barnett decision, the Supreme Court refused to hear an appeal from Kentucky's Insurance Commissioner, who had been overturned in barring Owensboro National Bank from selling insurance. The Court also overturned a Louisiana decision that prevented a subsidiary of First National Bank of Benham from selling insurance. *AB, 3/27/96, 4/2/96; NYT, 3/27/96; WSJ,* 3/27/96.

The OCC is finishing guidelines for insurance sales by banks. The guidelines cover where insurance can be sold; disclosures; anti-tying regulations; use of customer information; handling of complaints; director and manager oversight; applicability of state law in appropriate sales recommendations; guidance on promotional and sales literature; employee compensation; employee qualification and training. *AB, 2/1/96, 6/19/96.*

"30-Mile Rule"

The OCC has allowed 59 national banks to branch into other states since January 1994, under the authority of Section 30 of the National Bank Act (the so-called "30-mile rule"), which allows national banks to move their headquarters anywhere within a 30-mile radius. In May 1996, the U. S. District Court for the Northern District of Texas overturned an OCC decision to permit Commercial National Bank of Texarkana, Arkansas, to branch into Texas under the 30-mile rule. It ruled that the OCC, in relying on Section 30 of the Act, had ignored Section 36, which allows national banks only the same branching rights as state banks. The OCC is appealing the decision.

Thirteen states, including Arkansas, Colorado, Connecticut, Delaware, Iowa, Maine, Massachusetts, Michigan, New Hampshire, North Dakota, Oklahoma, Virginia, West Virginia; the District of Columbia; and the Conference of State Bank Supervisors supported Texas in its challenge.

Recent 30-mile rule approvals by the OCC include: The OCC granted approval for Embry National Bank, Atlanta, to move its main office across a county line under the 30-mile rule. The Community Bankers Association of Georgia had argued that the federal law did not apply and that the Embry branching decision violated state law and would result in state banks with restrictive charters converting to national charters. Some state banks in Georgia in recent years have converted to thrift charters that have nearly unlimited branching rights in the state. In February of 1995, it approved the Bank Midwest of Kansas move to Missouri; in March 1995, it approved the American National Bank and Trust move from Wisconsin to Illinois, and the headquarters relocation of NationsBank from Maryland to Virginia; and in January of 1996, it approved the relocation of Society Bank of Michigan to Indiana. None of these approvals will be affected by the Texas decision, but state banking departments in Michigan and Connecticut are pursuing legal remedies similar to the Texas case against the OCC. *AB 8/17/95, AB, 2/2/96, AB, 5/24/96, BBR, Vol. 66, No. 21, p. 948, 5/27/96, AB, 7/10/96.*

Revisions to Regulations

The OCC has proposed and adopted revisions to its regulations to further the goals of the Regulation Review Program by updating, clarifying, reorganizing, and streamlining regulations where appropriate to promote better and more efficient interaction between the OCC and the banking industry and the public at large. The intent is to eliminate unnecessary regulatory burdens that do not contribute to the safety and soundness of national banks or to accomplishing the OCC's other statutory responsibilities. *FR, 11/15/95, p. 57315.*

Interpretive Rules Updated, Codified in Regulation: The OCC issued a final regulation on February 9, codifying its interpretive letters in a single ruling. The final rule affirms that national banks may perform electronically all services that they are otherwise authorized to perform; adds new provisions clarifying the circumstances under which a main office or a branch office may be used for lending activities; and clarifies and codifies current OCC letters and case authority to include late fees, insufficient funds fees, annual fees and cash advance fees as components of interest. The final rule also clarifies rules regarding the lease or sharing of excess space with non-financial businesses; permits national banks to rely on corporate law, including state laws where the main office is located or incorporated; and updates letter of credit provisions. The OCC is continuing to study the issue of state licenses for national banks operating under federal law, and its prior rulings against this practice were therefore not codified in the final rule. *News Release, OCC, NR 96-13, 2/9/96.*

Security Devices and Procedures: The OCC is proposing to revise its regulation on minimum security devices and procedures for banks, reports of crimes and suspected crimes, and the Bank Secrecy Act for compliance. This proposal implements the new inter-agency suspicious activity referral process and updates and clarifies various portions of the regulation. *FR, 7/3/95, p. 34476; p. 34481 (FRB notice).*

International Banking: The agency is proposing to revise its regulations governing the international operations of national banks and the operation of foreign banks through federal branches and federal agencies in the U.S. The proposal updates, streamlines and consolidates various provisions and simplifies certain requirements. The proposal implements a requirement of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 for reducing an existing exemption to the prohibition on the acceptance by U.S. federal branches and agencies of foreign banks of retail deposits under $100,000. The exemption that allows acceptance of certain minimal ("de minimis") deposits up to five percent of branch deposits would be reduced to one percent, which is consistent with a similar FDIC proposal. A five-year phaseout period would be applied to deposits held in existing five percent de minimis accounts.

Real-Estate Lending and Appraisals: The OCC proposed to revise its rules governing real-estate lending, in order to modernize and clarify the real-estate lending rules and accomplish other objectives of the Regulation Review Program. *FR, 7/5/95, p. 35353.*

New Appeal Procedures Finalized: The OCC published its final rule modifying and clarifying national bank appeal procedures to comply with the requirements of the Riegle Community Development and Regulatory Improvement Act of 1994, which requires that all federal financial institution regulatory agencies establish an independent appeals process. National banks may request reviews through their immediate supervisory office or the OCC's ombudsman. Appeals must be submitted in writing, and the supervisory office or ombudsman has 45 calendar days to respond. Matters not subject to appeal are the appointment of receivers and conservators; preliminary exam conclusions; enforcement-related decisions; Freedom of Information Act requests for agency records; and rulemakings subject to the Administrative Procedures Act. *BBR, p. 294, 2/26/96.*

Proposal Allowing Banks to Exceed Loan Limits to One Borrower: The OCC has proposed that national banks be allowed to exceed the limits on loans to one borrower if two conditions are met. The loan must be secured by either personal property or real estate; and extension of additional credit puts the bank in a better position than foreclosing on the collateral. The proposal was published in the Federal Register on July 17, 1996, with comments due by September 16. *AB, July 17, 1996.*

New Bank Examinations Said to Reduce Regulatory Burden

In a survey of 725 community banks examined under the OCC's streamlined examination procedures for noncomplex community national banks, 83 percent of bankers said that the new examinations reduced their regulatory burden from prior examinations. Three-fourths or more of the surveyed banks examined between October 1, 1994 and June 30, 1995, said that the time required to prepare requested materials in support of the examination was reduced, that the examiners took up less of the bank's staff time with discussions, and that examiners were more focused in their reviews.

In a separate survey of Minnesota and North Dakota national banks, 95 percent strongly agreed that the exam scope and goals were clearly communicated prior to the exam, that the examination team acted professionally and provided useful information, and that their findings were clearly and effectively communicated at the completion of the exam. In this survey, 93 percent strongly agreed that examiners were responsive to bank needs over the past year without placing undue burden on banks, 88 percent strongly agreed that examiners presented accurate conclusions, their recommendations for corrective action were reasonable, and the report of examination was consistent with verbal discussions. Also, 82 percent strongly agreed that examination information requests were reasonable. The survey results are based on responses by 56 banks out of a total of 62 that were sent the questionnaire. *Press Release, OCC, 8/21/95.*

Pilot Project For Bank Auditor/Examiner Cooperation

Comptroller of the Currency Eugene A. Ludwig announced plans for a pilot program to test coordination of the respective review activities of national bank examiners and certified public accountants at ten large national banks. Once the banks are identified, examiners and auditors involved in each bank will share auditing and examination plans for the coming year. One possible outcome might be identification of a specific risk area upon which to focus and develop a plan for cooperation. The program is intended to generate: a) better coordination of procedures for reviewing common areas of concern to reduce examination and audit time; and b) opportunities to share information and data, which should assist in improving the efficiency of examinations and audits and in eliminating duplicative information requests. *News Release, OCC, 11/16/95.*

Treasury Study of Consumer and Small-Business Credit

The Department of the Treasury requested comment on the processes, and the effect of federal laws on those processes, by which credit is made available for consumers and small businesses. The request was issued pursuant to Section 330 of the Riegle Community Development and Regulatory Improvement Act of 1994, which requires the Treasury to conduct the study in consultation with the FRB, the Small Business Administration, the Department of Housing and Urban Development, OCC, OTS, FDIC, and NCUA, and submit a report to Congress. The purpose of the study is to identify procedures and federal laws that have the effect of reducing the availability of credit to consumers or small businesses, increasing the level of consumer inconvenience, cost, and time delays in connection with the extension of consumer and small-business credit, and the increasing costs and burdens on insured depository institutions, insured credit unions, and other lenders. *FR, 8/22/95, p. 43647.*

Pacific Northwest Flood Damages

The OCC is encouraging national banks to work with borrowers in the Pacific Northwest affected by floods by extending loan repayment terms, restucturing debt obligations, and easing loan documentation or credit extension terms for new loans, consistent with prudent banking policy. The OCC will also use expedited procedures to approve temporary facilities for national banks with branches that have been damaged by the flooding. The OCC district office in San Francisco has been designated the contact point for national banks in need of assistance. *OCC NR 96-15, 2/12/96.*

Thrift Becomes National Bank

On July 18, 1996, the OCC approved an application by the $7.5 billion Minneapolis thrift, TCF Financial Corp., to create four national banks to operate in the states of Minnesota, Illinois, Wisconsin, and Michigan. TCF stated that the 23-cent difference between the premiums charged by the BIF and the SAIF forced this action. Six other thrifts have also applied to the OCC for bank charters. The OCC decision followed an earlier decision by the FDIC to allow thrifts to shift deposits out of the SAIF, if the action was initiated by the customer. *AB, 7/19/96; FDIC PR-58-96, 7/31/96.*

Office of Thrift Supervision Review of OTS-Calculated Interest-Rate Risk

The OTS adopted new procedures for eligible thrifts to request an adjustment to their interest-rate-risk (IRR) component, as calculated by the OTS, or calculate their IRR exposure using their own computer models. An eligible institution may request an adjustment to its capital requirement if it can demonstrate that the accuracy of OTS' estimate of IRR exposure can be materially improved through the use of more-refined data or more-appropriate assumptions tailored to the specific institution. To be eligible, an institution must show that imposition of the IRR capital requirement as calculated by the OTS would cause the institution to move to a lower prompt corrective action category. The OTS intends to process requests for IRR adjustments within 75 calendar days from the date of their receipt. To allow for the implementation and evaluation of the new procedures, the OTS will delay invoking its IRR rule requiring thrifts with above-normal IRR exposure to adjust their regulatory capital requirement.

Thrift institutions with assets of more than $300 million, of which there are currently approximately 500, are required to file quarterly data with the OTS for calculation of their IRR exposure. They represent about one-third of the OTS-regulated industry. Any institution in this group that is well-capitalized may request to use its own internal IRR model in place of the OTS model in calculating its IRR capital requirement. An internal model must meet certain standards; for example, the model must use reasonable assumptions regarding future interest rates, prepayment rates for assets, and attrition rates for liabilities. The OTS intends to process such requests within 20 calendar days of their receipt. For thrift institutions with assets of $300 million or less, filing the quarterly IRR is voluntary. More than 85 percent of the approximately 1,000 thrifts in this group are voluntary filers. *NEWS, OTS, 8/23/95; Thrift Bulletin 67, 8/21/95.*

Regulatory Capital

The OTS adopted a rule that substitutes the term "available-for-sale equity securities with readily determinable market values" used in Statement of Financial Accounting Standard No. 115 for the current reference to "marketable equity securities" in the OTS definition of "common stockholders' equity." The OTS, in consultation with the other federal banking agencies, decided not to adopt its June 1994, proposal to include the SFAS No. 115 equity component in computing regulatory capital (see this Review, Winter 1995, p. 47). Savings associations, however, must follow this Standard for regulatory reporting purposes, as required by statute. The decision leaves in effect the OTS' requirement that nontrading debt securities be valued at amortized cost and nontrading marketable equity securities be valued at the lower of fair value or amortized cost for computing regulatory capital. This decision is consistent with the recommendation of the Task Force on Supervision of the FFIEC and the policies of the other agencies. *FR, 8/15/95, p. 42025.*

Policy on Independent Audits

The OTS provided the first detailed guidance on independent audits since the agency revised its audit regulation in November 1994. That regulation, designed to make audit rules for savings associations more consistent with those for commercial banks, takes into account an FDIC rule requiring annual independent audits for thrifts and banks with assets of $500 million or more. OTS retained authority to require an independent audit of any savings association or thrift holding company, regardless of size, if an audit is needed to address safety-and-soundness concerns. Associations with an examination rating of CAMEL 3, 4, or 5 are automatically required to obtain an independent audit. Otherwise, associations can expect to get a written notice from OTS when an independent audit is required for other safety-and-soundness purposes. An institution with the above ratings may request a waiver of the audit requirement. OTS will consider granting a waiver if the audit is not likely to help solve the problem that led to the poor rating. For those institutions not required to have an annual independent audit, the practice is encouraged by the OTS. Thrift holding companies must have an annual independent audit if the holding company controls subsidiaries that have aggregate consolidated assets of $500 million or more. *Regulatory Bulletin 32-1, OTS, 8/16/95; NEWS, 8/18/95.*

Examination Performance Evaluated

The OTS surveyed the institutions it regulates to determine how well the agency is living up to standards of service that it adopted in September 1994, in response to the comments received from thrift institution managers and directors on areas where the OTS needed to improve the examination process. The agency scored almost a 90-percent success rate in meeting most of its targets. For example, 91 percent of surveyed institutions said the OTS had met its goal of meeting with them at least semiannually between examinations and making a supervisory team available to meet on an as-needed basis. In other categories, 98 percent of surveyed institutions agreed that OTS' examiner-in-charge scheduled a meeting with the thrift's chief executive officer on the day the examination commenced, and that meetings were held at least weekly with institution personnel to convey findings and discuss concerns as the examination progressed. The lowest score a 69-percent success rate related to examination staff continuity from one examination to the next. The OTS said the logistics of deploying examiners and the location of thrifts and examiners will make it hard to improve, but the agency will do its best to provide greater staff continuity. *NEWS, OTS, 11/25/95.*

Examination Strategies Revised

The OTS revised its examination strategy and work paper documentation, pursuant to the Riegle Community Development and Regulatory Improvement Act of 1994, to apply an 18-month cycle to smaller insured institutions that: a) are not currently subject to a formal enforcement proceeding or order by the OTS or the FDIC; b) have a composite 1-CAMEL rating and total assets of less than $250 million, or a composite 2-CAMEL rating with total assets of $100 million or less; c) are well-capitalized; d) have a management component rating of 1 or 2; e) have had no change in control of the institution since completion of the last full-scope examination; and f) have had a full-scope safety-and-soundness examination or alternating state examination report submitted since November 1, 1994. The OTS will continue to conduct full-scope safety-and-soundness examinations in all other institutions on a 12-month examination cycle. Full-scope, on-site examinations conducted by state authorities may be accepted on an alternating basis in lieu of an OTS examination when such examinations meet OTS requirements. The Preliminary Examination Response Kit (PERK), which is sent to institutions prior to examinations, was revised in several respects to reduce regulatory burden, update references, and eliminate redundancies. *Regulatory Bulletin 32-2, OTS, 8/22/95.*

Actions to Reduce Regulatory Burden

As part of an initiative to reduce regulatory burden and to implement the Community Development and Regulatory Improvement Act of 1994, the OTS proposed eliminating regulations that are either outdated or duplicative, these constituting eight percent of all OTS sections in the Code of Federal Regulations.

Among the regulations and policy statements the agency proposes to eliminate are requirements for counter statements, which duplicate information available elsewhere; unnecessary procedures for savings withdrawal requests; and outdated limitations on the sale of merchandise in connection with soliciting savings accounts. The OTS expects to issue over the next year a series of proposals to make significant burden-reducing changes in a number of key areas of its regulations, including regulations governing lending, subsidiaries, insurance, preemption, and adjustable mortgages. *NEWS, OTS, 8/28/95; FR, 8/28/95, p. 44442.*

The OTS proposed streamlining the Thrift Financial Report (TFR), including a 40-percent reduction in its content. The TFR is filed quarterly by 1,500 savings-and-loan associations to report their financial condition. As proposed, the consolidated report that institutions presently file would be retained, but the separate reports for the parent institution and subsidiaries would be eliminated. Additionally, only data critical to meeting supervisory needs or statutory mandates would be collected. The proposed changes would also make the data more comparable to the information contained in the commercial bank Call Report. The agency would use the revised TFR beginning with the June 1996, reporting cycle. *NEWS, OTS, 8/24/95; FR, 8/24, p. 44116.*

The OTS is discontinuing an attorney letter that is used to obtain certain information prior to the examinations of thrift institutions. The OTS had been the only banking agency to use an attorney letter. Essential information on foreclosures, litigation, legal fees and documents and funds controlled by the attorney will be obtained directly from the institution during the examination process. The agency will continue to request information on contingent liabilities, such as the feasibility of settling law suits and the probable time of settlements, as part of its pre-examination package, but directly from the institution. *NEWS, OTS, 8/4/95.*

On June 25, 1996, the OTS proposed a rule to update, shorten and make more flexible the rules governing the charters and bylaws of federal associations. The proposal seeks to reduce charter and bylaw rules and policy statements on corporate governance from 33 to 24, a reduction of 27 percent. Comments are due by August 26, 1996. *Transmittal 151, OTS, 7/9/96; FR, 6/25/96, pp. 32713 - 32728.*

Electronic Banking Task Force

The OTS created an Electronic Banking Task Force, which will look at "the whole range of electronic banking issues from the Internet to smart cards," an official said, and will identify the risks to financial institutions and to their customers. It is noted that the first financial institution to offer banking services on the Internet, Cardinal Bancshares, Inc., through its subsidiary, Security First Network Bank, Pineville, Ky., received approval from the OTS last May and began electronic operations on the Internet in October. Customers can open new accounts and transact business such as transferring funds between accounts and paying bills. Cardinal was not required to ask the OTS for permission to operate on the Internet, but did so as part of its application to set up the new subsidiary, Security First. In approving the application, the OTS stipulated that the thrift had to address a number of electronic security issues. *NEWS, OTS, 11/20/95.*

Minority-Owned Thrifts

Assets of minority-owned federal savings banks and savings-and-loan institutions rose 26 percent by $5.9 billion in 1995, according to the OTS. This compares with a decline of 0.4 percent for all 1,437 federal savings banks and savings-and-loans in 1995. The OTS attributes the rise to growth in consumer lending and small-business lending in minority communities. *AB, 5/24/96.*

Courts Restrict OTS' Ability to Enforce Net-Worth Agreements

The Supreme Court refused to consider an OTS appeal of a U.S. Court of Appeals decision restricting the OTS' ability to enforce net-worth maintenance agreements against owners of thrifts. In this case, United States vs. Rapaport, the U. S. Court of Appeals for the District of Columbia ruled that the OTS could enforce net-worth agreements against only those thrift owners who recklessly disregarded the law or personally profited by signing net-worth agreements. *AB, 1/25/96.*

National Credit Union Administration Field of Membership and Chartering Policy

The NCUA proposed amending its policies so that senior citizen and retiree groups will be required to meet the same conditions as other associational groups in order to qualify for a federal credit union charter or addition to an existing charter. In determining whether a group satisfies the normal common bond requirement, NCUA will consider the totality of the circumstances, such as whether the members pay dues, have voting rights, hold office, hold meetings, whether there is interaction among members and whether the group has its own bylaws.

Until the Board approves a final policy, it is continuing its moratorium on FCUs adding self-created senior citizen/retiree groups to their field of membership. The moratorium has no effect on groups that are already in an FCU's field of membership and it does not apply to the addition of senior citizens groups that have the characteristics of an association.

The Board proposes that FCUs continue to be allowed to add low-income groups formed solely for the purpose of seeking credit union service. *FR, 10/4/95, p. 51936.*

Investment and Deposit Activities

The NCUA proposed a rule that would add restrictions on some securities that have been determined to be too risky for credit unions, broaden authority in certain areas, and require that a credit union's staff and board of directors fully understand the potential risk characteristics of its investment options. The agency has concluded that investment policies with well-defined parameters and enhanced monitoring and reporting of investment risks are needed to strengthen credit union investment-risk management. The proposed rule recognizes that credit union investment risk is largely interest-rate, rather than credit (default) risk, and that a regulation designed to prohibit particular securities can fail to reflect the changing financial environment. The proposed rule allows a credit union to operate on one of three levels. A credit union could invest in fully-insured CDs and shares and deposits in corporate credit unions, and, if limited to these investments, the institution would not have to meet certain requirements, among which are conducting collateralized mortgage obligations (CMO) testing, establishing a trading policy and reporting on these activities, reporting monthly on the fair value of each investment, and calculating the impact on its portfolio of a 300-basis point parallel shift in interest rates. At the next level, a credit union could invest in potentially more-risky securities in an amount up to capital and would have to comply with most of the proposed rule's policy and reporting requirements, but not the 300-basis-point shift analysis. Finally, at the most sophisticated level, a credit union investing in potentially more-risky securities in an amount exceeding capital would be subject to all of the policy and the reporting requirements. *NCUA News, 11/16/95; FR, 11/29/95, p. 61219.*

Incentive Pay For Lending Activities

To reduce regulatory burden, the NCUA is amending its regulations to give member-elected credit union boards more flexibility to determine compensation policies, including incentive pay, for certain activities related to credit union lending. Currently, the agency's rules prohibit officials and certain employees of federally insured credit unions from receiving either incentive pay or outside compensation for these activities. The final rule will allow federal credit unions to pay: 1) to any employee, including a senior management employee, an incentive or bonus based on the overall financial performance of the credit union; and 2) to any employee, except a senior management employee, an incentive based on a loan made by the credit union, provided that the board of the credit union has established written policies and internal controls in connection with the incentive or bonus and monitors compliance with them at least annually. In addition, a credit union's volunteer officials and non-senior management employees, and family members of officials and all employees, may receive compensation from an outside party for a service or activity performed outside the credit union, provided that neither the credit union nor the official, employee, or family member has "steered" anyone to the other party.

The NCUA reserves the right to take exception to any compensation plan for safety-and-soundness reasons. The amendments are effective October 4, 1995. *FR, 10/4/95, p. 51886.*

Supervisory Committee Audits

The NCUA is proposing to amend its regulations governing credit union supervisory committee audits and verifications to clarify audit requirements in targeted risk areas. Most of the additional requirements are not applicable to credit unions that do not employ a compensated auditor. The expanded scope is intended to provide credit unions an enhanced audit product in several areas, among which are internal controls, cash, loans, related-party transactions, and the detection and reporting of errors and irregularities. The more definitive audit scope is designed to address and to reduce confusion that occurs when the supervisory committee and the compensated auditor agree that the audit engagement will consist of less than the full scope of a supervisory audit. For example, the supervisory committee may not realize that it remains responsible for performing the additional work needed to "fill the gaps" and produce a complete supervisory audit. Credit unions that employ compensated auditors would be required to memorialize the terms and conditions of the engagement in a comprehensive engagement letter that would constitute an enforceable contract.

Along with the existing requirement for a written audit report would be a requirement for two additional written reports where applicable: 1) a report of internal control exceptions or reportable conditions noted, if any, and 2) a report of irregularities or illegal acts noted during the audit, if any. These requirements do not necessitate any additional work, as they report information already obtained in the normal course of the supervisory committee audit. *FR, 11/2/95, p. 55663.*

Appraisals

Pursuant to Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, the NCUA amended parts of its real-estate appraisal regulation that are concerned with minimum appraisal standards, safety and soundness, unavailable information, appraiser independence and other aspects. The aim was to simplify compliance and reduce costs. For example, credit unions will be permitted to use an appraisal that was prepared for a different type of financial institution, including a mortgage bank. The agency will continue to require credit unions to get appraisals on any residential real-estate loan of more than $100,000, while banking regulators have set a $250,000 minimum. *FR, 10/4/95, p. 51889; AB, 10/5/95, p.8.*

Truth in Savings

The NCUA extended the compliance date to January 1, 1997, in respect to Part 707 of its regulations for nonautomated and insufficiently automated credit unions that have assets of $2 million or less. The extension gives these credit unions continued immunity from compliance until Congress has acted on its contemplated regulatory relief initiatives, which might ultimately exempt their compliance with TIS. The agency has twice before extended the Part 707 compliance date for certain small, underautomated credit unions. The compliance date for all other credit unions remained January 1, 1995. *FR, 11/14/95, p. 57173; 8/3/94, p. 39425.*

Management Interlock Rule Upheld

A U.S. district court in Virginia upheld an NCUA rule approved last fall that prohibits shared management between the Credit Union National Association (CUNA), which is the industry's largest trade group, and corporate credit unions (see this Review, Spring 1995, p. 44). The decision cited conflicts of interest and deference to the NCUA's contention that such conflicts could threaten the safety and soundness of the nation's credit union system. About half of the 43 corporate credit unions across the country are affected by the NCUA's rule. *AB, 10/2/95, p. 8.*

Federal Housing Finance Board Affordable Housing Program

The Federal Housing Finance Board (FHFB) adopted a rule, effective October 25, 1995, to authorize a Federal Home Loan Bank (Bank) to set aside a portion of its Affordable Housing Program (AHP) contribution to assist low- and moderate-income, first-time home buyers to purchase homes. In addition, the final rule permits a Bank to establish a home ownership set-aside program, with other requirements, subject to prior approval of the Board. Section 10 of the Federal Home Loan Bank Act requires each Bank to establish a program to subsidize the interest rate on advances to members of the Federal Home Loan Bank System engaged in lending for long-term, low- and moderate-income, owner-occupied and affordable rental housing at subsidized interest rates. The Board's regulation requires each Bank to make a specified annual contribution to fund its AHP. During each calendar year, each Bank accepts applications for funds from its members during two of four quarterly funding periods. AHP funds are awarded to applicants through a competitive scoring process set forth in the AHP regulation. *FR, 9/25/95, p. 49327.*

Mortgage Rates

The FHFB reported that interest rates on conventional 30-year fixed-rate mortgages increased in April 1996, to 8.05 percent, and is higher than in any month since May 1995. Similarly, rates on 15-year fixed-rate loans increased to 7.77 percent in April, 23 basis points higher than in the previous month. Thirty-one percent of conventional loans closed in May were adjustable-rate loans, the highest percentage since last May.

The data were based on 12,839 reported loans from 245 lenders and excluded FHA-insured and VA-guaranteed mortgages, refinancing loans, and balloon loans. *FHFB 96-28, 6/27/96.*

STATE LEGISLATION AND REGULATION Interstate Banking/Branching

Alabama: A new law permits acquisitions of banks by out-of-state banks or bank holding companies, effective September 29, 1995. Interstate branching is allowed, effective March 31, 1997. Alabama banks may establish and operate one or more branches in another state. An out-of-state bank may branch into Alabama only by acquiring a bank in the state that has operated for five or more years. After entry, an out-of-state bank with branches in Alabama may branch de novo or by acquisitions to the same extent that in-state banks may branch. The bill also provides for licensing, application and other requirements for foreign bank branches, offices, or agencies operating in the state. *BBR, 8/28/95, p. 344.*

California: Banks are permitted to branch through acquisitions into California under a law enacted in response to the Riegle-Neal Act. A bank must be at least five years old before it can be acquired by an out-of-state banking organization. *BBR, 11/13/95, p. 795.*

Illinois: An opt-in law permits state banks to establish out-of-state branches, and out-of-state banks to branch in Illinois, beginning June 1, 1997. State banks will be permitted to merge with out-of-state banks; however, the law does not allow direct branch acquisitions or de novo branching. Several restrictions relating to the acquisition of Illinois banks by out-of-state bank holding companies are eliminated. Among other provisions, the state Commissioner of Banks is authorized to examine branches of out-of-state banks and to participate in reciprocal arrangements concerning examinations of banks. The law sets no age limit on banks being acquired and allows banks to act as agents for out-of-state affiliates. *BBR, 8/7/95, p. 262; Northwestern Financial Review, 8/19/95, p. 15.*

New Hampshire: The Governor signed opt-in legislation permitting interstate branching, effective June 1, 1997, but not allowing de novo branching or partial bank acquisitions. As permitted under the Reigle-Neal Act, the law prohibits the interstate acquisition of banks in the state that are less than five years old. A 20-percent cap on the portion of the market an institution may control through an acquisition is retained. *BBR, 7/31/95, p. 209.*

Wisconsin: A new law allows out-of-state banking organizations to branch into the state by acquisition of existing banks and bank holding companies, but not by de novo branching. Only banks operating for five years or longer may be acquired by out-of-state firms. Previously, only banking firms within a nine- state region could acquire banks in Wisconsin. *BBR, 11/6/95, p. 757.*

Intrastate Branching

Nebraska: One bank has received regulatory approvals, and two others have filed applications, to branch within the state by means of creating a savings-and-loan charter and merging the proposed office or offices into the bank. The state's law allows banks to branch through the purchase of an existing bank that is at least 18 months old, but not through de novo bank branches. *Northwestern Financial Review, 8/5/95, p. 24.*

Court Rulings on Fee and Service Charges

The U.S. Supreme Court ruled unanimously on June 3, 1996, that national banks can charge any late-payment fees permitted by their home state, regardless of the law of the state where the cardholder lives. The ruling, Smiley v. Citibank, upholds a 1995 ruling by the California Supreme Court dismissing a suit against Citibank by California residents charging that Citibank late fees were illegal under California law. Citibank conducts its credit-card operations from South Dakota, which has no cap on late fees or other credit-card charges.

The U.S. Supreme Court ruling applies explicitly to nationally chartered banks regulated by the OCC, but it is expected to be applied to federally insured state-chartered banks as well. Previous to this decision, the Comptroller of the Currency, the state of Delaware, and the Colorado Supreme Court had ruled that fees on credit cards represented interest and were therefore allowable. A Pennsylvania superior court in 1994 and the New Jersey Supreme Court in November 1995 had ruled otherwise.

The California Supreme Court ruled that out-of-state credit-card banks are not governed by the state's restrictions on fee and service charges, because the National Bank Act gives a bank's home state the power to impose these restrictions. The ruling was based on the definition of "interest," which the Court said includes late fees and all other money paid to the creditor. *AB, 9/6/95; 11/22/95; Federal Reserve Bank of Philadelphia, Banking Legislation and Policy, Volume 14, Number 4, pp. 1-2; The New York Times, 6/4/96.*

Annuities Brokerage

Connecticut: The Department of Insurance, in a partial settlement of a lawsuit challenging state restrictions, gave approval for Shawmut National Corp. to sell annuities throughout the state. The state Attorney General said his office will propose legislation to give state banks the same power. Under the settlement, Shawmut agreed that all employees who sell annuities will apply for licenses from the Department, and the state agreed that all currently licensed employees will not need to reapply. *AB, 7/28/95, p.2.*

Florida: A proposed rule provides guidelines for insurance agents and deposit-taking financial institutions in the sale of annuities. The rule would affect Florida-chartered banks, savings-and-loan associations, and savings banks, and federally chartered savings-and-loan associations and savings banks. National banks already are permitted to sell annuities under federal law. Consumer protections include a requirement that institutions disclose orally, in writing, and with signs, that annuities are not insured by the FDIC or the Securities Investor Protection Corp. (SIPC), and are subject to investment risk. Sales could only be made by a licensed insurance agent, and employees would not be permitted to perform annuities services and banking services for a customer at the same time. *BBR, 8/28/95, p. 341.*

A state appeals court ruling that allows state-chartered banks to engage in any activity permitted to national banks opens the way for state banks to sell annuities in Florida. At least two national banks have started selling annuities in the state following the U.S. Supreme Court's ruling in January in the Valic case, in which the Court upheld a decision of the OCC that selling annuities is "incidental" to banking and a permissible activity under the National Bank Act (see this Review, Spring 1995, p. 39). *AB, 8/25/95, p. 2.*

Compliance Self-Testing Privilege

Illinois: Under a bill passed by the legislature, information obtained or discovered by a bank or thrift in the course of conducting an internal audit or review cannot be used as evidence against the bank or thrift in a civil action. Documents that are prepared in connection with a review conducted by a compliance review committee would remain confidential and would not be discoverable as evidence against a bank or thrift in any civil action, other than a civil action initiated by a state or federal regulator. *Illinois Banker, 9/95, p. 17.*

EFT Networks

Illinois: A bill passed by the legislature, amending a 1979 law, eliminates restrictions on the kinds of transactions and other banking-related activities that may be carried out by customers of financial institutions at various electronic funds transfer facilities, and authorizes EFT networks to process deposits on an interstate basis, consistent with the powers of brick-and-mortar branches and with other laws applicable to financial institutions. The revised law retains the right of the Banking Commissioner to audit networks but the networks no longer would be required to make quarterly and annual filings with the Commissioner. *Illinois Banker, 9/95, p. 25.*

State Regulator Accredited

Kansas: The Conference of State Bank Supervisors has issued its accreditation to the Office of the Bank Commissioner. The Office supervises 323 state-chartered financial institutions with assets of more than $14.8 billion, and over 80 trust departments and independent trust companies. Thirty-four state banking departments thus far have received CSBS accreditation. *Bank News, July 1995, p. 45.*

Examination Cycle Extended

New York: Effective January 1, 1996, the Banking Superintendent is permitted to examine certain state-chartered banks every 18 months, instead of once a year. To be eligible for the longer cycle, a bank's total assets must be less than $250 million, and the institution must be well-capitalized and well-managed. These requirements parallel the criteria for the longer cycle applicable to federally examined banks under the Riegle Community Development and Regulatory Improvement Act of 1994, except that the state law applies also to safe deposit companies, uninsured limited-purpose trust companies, and other uninsured entities holding state banking charters. *BBR, 8/7/95, p. 263.*

Feedback From Examinations

New York: The Banking Department has developed a follow-up questionnaire by which banks can evaluate the examination process and identify problems. The feedback will assist the Department in monitoring the effectiveness of its communications with state-chartered banks, the reasonableness of its examination requests, and other aspects of the program. *AB, 8/16/95, p. 7.*

Regulatory Reorganization

Wisconsin: Government departments that regulate banking, savings-and-loans, and securities will be transferred to a new Department of Financial Institutions, beginning July 1, 1996. Among other changes, the new Department will take over regulation of mortgage banking, and will administer the Wisconsin Consumer Act. The Department also will have certain administrative responsibilities with respect to credit union regulation that otherwise will remain in a separate Office. Savings on salary costs alone from the consolidation are estimated at nearly $900,000 annually. *Northwestern Financial Review, 10/7/95, p. 36.*

State Legislative Activity on Mergers

Kansas: The Kansas state legislature is considering legislation authorizing the state to block bank mergers that would result in the loss of jobs. Under the current bill, acquirers would be required to file a statement with the Banking Ccommissioner concerning likely job losses resulting from the merger. The Commissioner would be empowered to block the merger if job loss would be severe. *AB, 2/1/96.*

Mississippi: The legislature is considering a bill that would provide tax credits to institutions that maintain banking jobs following a merger. *AB, 2/1/96.*

Limits on Credit Union Membership

Utah: The Utah State Supreme Court reversed a lower court's dismissal of a suit brought by the Utah Bankers Association against the Credit Union Service Centers of Utah and Utah's Commissioner of Financial Institutions. The suit sought to block credit unions from having members from more than one county of the state. The case has been remanded to District Court and will be refiled. *AB, 3/19/96.*

State Savings Bank Charter

Michigan: Michigan became the 30th state to create a state savings bank charter. The new charter requires that at least 50 percent of the institution's assets be concentrated in mortgage-related loans and investments. The new charter will permit the state's 27 federally chartered savings institutions to continue to operate as thrifts regardless of federal action, and removes the OTS as their primary regulator. Those thrifts operating under the new charter will have the state as their primary regulator with the FDIC as a secondary regulator. *AB, 7/19/96.*

State Credit Union Deposit Insurance to End

Washington: The Washington Credit Union Share Guaranty Association, a Washington state corporation providing deposit insurance for 74 state credit unions, voted to dissolve the insurance fund within the next three years. The affected credit unions must submit applications to the National Credit Union Administration for federal deposit insurance by the end of 1996. *AB, 1/29/96.*

BANK AND THRIFT PERFORMANCE Commercial Banks' Earnings in 1995

Insured commercial banks reported a record $48.8 billion in net income for 1995, an increase of 9.4 percent over 1994's previous record earnings of $44.6 billion. Fourth-quarter 1995 net income was $12.1 billion, the second-highest quarterly net income ever after third-quarter 1995 record net income of $13.8 billion. All but three percent of commercial banks reported positive earnings in 1995, and 68 percent reported higher earnings than in the previous year. Industry 1995 ROA increased to 1.17 percent, a slight improvement over the 1.15 percent ROA reported in 1994. This was the third consecutive year that the ratio exceeded one percent.

Contributing to the growth in earnings in 1995 were lower deposit insurance premiums, made possible by the recapitalization of the BIF. The higher earnings reflected the banks' emphasis on expanding their loans, particularly home mortgage loans and other loans to consumers, compared to other assets. The higher proportion of loans has given support to average yields and net interest margins.

Contributing to 1995 record earnings was a 5.2-percent increase in net interest income over 1994 levels. The industry's 1995 seven-basis-point decline to 4.29 percent in net interest margins was more than offset by a 7.7-percent increase in interest- earning assets. Additionally, 1995 results showed an increase in noninterest revenue of $6.2 billion over previous year revenues, an 8.1-percent increase, resulting from strong 1995 growth in fee income. Securities sales also contributed $545 million in gains in 1995, a $1.1-billion increase over 1994 net losses of $572 million.

Delinquency measures overall showed improvement. Noncurrent assets and other real estate owned to assets fell to .85 percent in 1995 from a level of 1.01 percent in 1994. This represented the fourth consecutive year of decline in this ratio. Noncurrent loans (more than 90 days past due or not accruing interest) fell by 1.1 percent and real estate owned fell by 36.6 percent in the fourth quarter of 1995 from fourth-quarter 1994 levels. Short-term delinquencies (loans and leases 30-89 days past due) rose during the same period, however, increasing 20.2 percent over fourth-quarter 1994 levels. Net charge-offs increased 8.2 percent, and the provision for loan losses increased 14.5 percent in the fourth quarter of 1995 over fourth-quarter 1994 levels.

Banks' equity capital rose to 8.11 percent of total assets in 1995. Total assets grew to $4,313 billion in the fourth quarter of 1995, a 7.5-percent increase over the $4,011 billion in assets four quarters earlier.

Six insured commercial banks failed in 1995, compared to 11 in 1994. The number of commercial banks on the FDIC's "Problem List" for 1995 dropped to 144 institutions from 247 in 1994. Assets of "problem" banks fell by $16 billion during the year, to $17 billion in 1995.

FDIC-insured savings institutions earned $1.8 billion in the fourth quarter of 1995, bringing full-year 1995 earnings to a record $7.6 billion. Net income for the quarter was $181 million higher than in the fourth quarter of 1994. Full-year average return on assets rose to .79 percent, the highest ratio since 1962. Profits were $1.3 billion higher in 1995 than in 1994. Net interest margins experienced their first quarterly increase since 1993, rising seven basis points to 3.12 percent in the fourth quarter. Thrift institutions' total assets increased by $1 billion during the quarter, and in the 12-month period grew by a modest 1.7 percent. The industry's equity capital as a percent of assets, 8.39 at quarter end, was the highest since 1951. The number of "problem" institutions in 1995 dropped by 22 to 49, and their assets declined to $14 billion. The total number of insured savings associations in operation fell by 31 to 2,029 in the fourth quarter, a loss of 5.7 percent during the 12-month period, and represented a continuation of the downtrend beginning in 1990. *The FDIC Quarterly Banking Profile, Third Quarter, 1995 and Fourth Quarter, 1995.*

First-Quarter 1996 Preliminary Earnings

Insured commercial banks reported net income of $12.0 billion in the first quarter of 1996, an 8.2 percent increase over the first quarter of 1995. This was the third consecutive quarter that net earnings exceeded $12 billion. More than two-thirds of banks reported higher earnings than a year ago. Higher net interest income was primarily responsible for the increased earnings. Net interest income rose $2.2 billion over levels a year earlier, reflecting a significant increase in interest-earning assets over the year. Higher noninterest revenues also contributed to the strong earnings. The average return on assets was 1.12 percent for the quarter. One negative, however, was that noncurrent loans rose for only the second time in the last five years, increasing $659 million during the quarter.

Savings institutions reported net earnings of $2.5 billion in the first quarter of 1996 and an annualized ROA of 1.01 percent. These results represented the highest quarterly net income and ROA ever reported by the industry, and the first time ROA has exceeded one percent. However, exluding gains on the sale of branches and securities, average ROA for the industry for the quarter declined to 0.83 percent. This lower ratio still represents an improvement over previous quarters. Net interest margins rose to 3.19 percent from 3.12 percent the previous quarter, the second consecutive quarterly increase in margins. Almost 80 percent of thrifts with more than $1 billion in assets reported improved earnings over earnings a year ago. Less than half (49 percent) of smaller thrifts reported higher earnings. *The FDIC Quarterly Banking Profile, First Quarter, 1996.*

Depository Institutions' Retail Fees Surveyed

Few cases were found of statistically significant nationwide increases in fees in 1993-1994 for either banks or savings associations, the FRB said in its fifth annual report to Congress on retail fees and services of depository institutions.

With respect to individual services, the changes in the proportion of institutions that charge a fee were about equally divided between increases and decreases. The report was based on surveys of 1,050 institutions (650 banks and 400 savings associations) in 1994, and 330 institutions in 1993. The fee and availability data from surveyed institutions covered noninterest checking accounts, NOW accounts, savings accounts, money orders involving insufficient funds, overdrafts and automated teller machines.

Among the changes detailed in the report, the average minimum balance for the single-fee NOW account to avoid a monthly fee required by banks increased from $971 to $1,055. The proportion of savings associations offering no passbook accounts increased from just under 18 percent to 20 percent. The nationwide proportion of banks offering ATM services remained at approximately 70 percent, while the proportion of savings associations offering the service increased from 45 percent to 61 percent. The proportion of banks charging an annual fee on credit cards increased from four percent to 13 percent, while savings associations levying an annual charge increased from nine percent to 18 percent.

The report found that in most cases the average fees charged by out-of-state banks defined as banks headquartered or owned by an organization headquartered in a state different from that of the surveyed bank are significantly higher than those charged by in-state banks. In some cases, however, out-of-state banks require lower minimum balances to open some types of accounts and are more likely to offer free checking. It is noted that out-of-state banks tend to be larger than in-state banks and are probably more concentrated in large urban areas, where costs can be higher. *Annual Report to the Congress on Retail Fees and Services of Depository Institutions, FRB, 9/95.*

Consolidation in Banking

Recent banking consolidation in California, a state whose banking structure is relatively free of restrictions on branching and other artificial barriers, may be an indicator of the consolidation that may eventually occur nationally after the elimination of these barriers. The number of banks in California rose sharply in the early 1980s and then remained relatively stable during the second half of the decade and into the early 1990s, largely because of the strong economy. But from mid-1990 through early 1993 the state experienced a severe recession, which affected in particular the smaller community banks in the southern part of the state. Fewer new banks, more failures, and a number of voluntary mergers caused the number of banks operating in California to fall from 516 at the end of 1990 to 399 in 1994, or 23 percent. Banking offices in the state, totaling 5,555 in 1991, declined by 20 percent to about 4,400 in the next two years.

Nationally, the number of banking institutions decreased from approximately 15,000 in 1984 to 10,740 in 1994, a 29-percent decline. There were failures during the period of about 1,300 banks, most of which were absorbed into other banking firms; however, the decrease resulted mostly from other voluntary mergers and acquisitions. The number of banks declined as the industry adjusted to changing competitive conditions, and in response to a changing regulatory environment including the liberalization of state branching laws. The number of banking offices continued to increase into the early 1990s. Over 65,500 banking offices were in operation at the end of 1992, nearly 9,000 more than in 1984, and the number per population unit was slightly higher in 1994 than ten years earlier. It is suggested that the contraction of the thrift industry, wherein from 1988 to

1993 the number of savings-and-loan offices fell from about 26,000 to 16,000, may have temporarily eased pressures on some banks to trim branch networks. Bank employment nationally declined by about 6.3 percent between 1985 and 1995, during a time of rapid advances in bank services automation.

The California experience suggests that if interstate branching restrictions and other artificial barriers are eliminated, the number of U.S. banking institutions could eventually be further reduced by one-half or more; and demonstrates that substantial reductions in bank offices across a state can occur over a relatively short period of time, especially when large banks are involved. *Weekly Letter, Federal Reserve Bank of San Francisco, 10/27/95.*

Boston Banks Increase Minority Lending

Since the publication of several reports dating from about six years ago on banks' lending to minorities in the Boston area, there have been significant improvements in mortgage lending to black borrowers and to persons with low- and moderate-incomes, according to a recent study by J. T. Campen. The share of black borrowers grew from 16.2 percent of all loans in 1990 to 20.1 percent in 1993. For Hispanic borrowers, the increase in the share of total loans was much less, from 5.1 percent to 5.7 percent. Denial rates for blacks and Hispanics were each reduced by almost half between 1990 and 1993: blacks, from 32.7 percent to 17.5 percent; and Hispanics, from 25.3 percent to 13.8 percent. Denial rate ratios for blacks and Hispanics, to whites, in the Boston area dropped from 2.00/1 to 1.49/1, and from 1.55/1 to 1.18/1, respectively. The national black/white denial ratio in 1993 was 2.22/1, and the Hispanic ratio, 1.64/1. Loans to low- and moderate-income borrowers in the study area rose from 27.3 percent of all loans in 1990 to 38.9 percent in 1993.

Among other results, the study found that virtually all of the increase in the mortgage lending to minority and low- and moderate-income borrowers came from Boston's six largest banks. It is noted that during the study period, the smaller banks in the area lost substantial total market share due to bank failures and intensified competition from the larger banks and unaffiliated mortgage companies. The increased lending to low- and moderate-income groups may have resulted in part, the report says, from the prevailing economic conditions during the study period, wherein housing prices fell, unemployment declined as the nation and region recovered from recession, and interest rates for 30-year, fixed-rate mortgages fell to less than seven percent, the lowest level in over 25 years. The improved performance, however, by the large banks reflects their strong initiatives to increase lending to under served borrowers and neighborhoods. *A Progress Report, Massachusetts Community and Banking Council, July 1995, pp. 60-67.*

Interstate Banking and Small-Business Lending

A recent report issued by the OCC is concerned with whether subsidiaries of out-of-state bank holding companies (OSHCs) will make fewer, possibly higher priced, small-business loans than other banks. The study also examines whether smaller independent banks are able to compete effectively against subsidiaries of larger out-of-state and in-state holding company organizations in this product line. Small-business lending levels, prices, and margins for a sample of 1,377 banks located in Illinois, Kentucky, and Montana are analyzed.

The volume of small-business lending by out-of-state bank holding company subsidiaries was found to compare favorably with both independent banks and in-state bank holding company subsidiaries. Out-of-state holding company subsidiaries do not systematically discourage small-business borrowing through their loan pricing. Small-loan rates at OSHC bank subsidiaries generally are lower than those at other types of banks. Although their marginal costs are higher, OSHC subsidiaries appear to be willing to accept lower margins on small commercial loans. The results also demonstrate that independents do not appear to be at a competitive disadvantage relative to OSHC subsidiaries, at least in this particular product line. Their marginal loan costs are typically below, and their margins typically exceed, those at either class of holding company subsidiary. *Economic and Policy Analysis Working Paper 95-4, OCC, 9/95.*

Smaller Banks Less Affected in Banking Downturns

From 1990 to the end of 1994, a decline occurred in the number of banking organizations in the U.S., from 12,385 to 7,998, concentrated in the smaller banks. In 1980, there were over 12,200 banking firms in the U.S. having assets under $1.3 billion, and as a group they controlled about one-third of the nation's banking assets, while in 1994 the number of organizations of this size (measured in 1980 dollars) had droppped to about 7,850 and their asset share had fallen to 22 percent. In these trends there are differences between regions, and in the regions that experienced severe banking sector difficulties, small banks are seen to have more successfully maintained their market share. In the Eleventh Federal Reserve District which consists of Texas, southern New Mexico, and northern Louisiana nearly one-third of regional bank assets were controlled by banking organizations with under $220 million in total assets (in 1980 dollars) in both 1980 and 1994.

As an indication of the smaller banks' ability to operate under unfavorable economic conditions, the return on assets of organizations with assets under $1.3 billion tended to remain above that for large banks in all except four years of the 1980-94 period. In addition, the return on assets of large banks has fluctuated more over time than it has for small banks. These differences between small and large banks have been even greater in the Eleventh District, and also in the First Federal Reserve District (New England states) which experienced a severe regional banking downturn following the collapse of its real-estate market at the end of the 1980s.

Recent cycles in bank profitability have tended to mirror cycles in asset quality, as measured by the troubled-asset ratio, ratio of past-due loans, nonaccrual loans and other real estate owned to gross assets. At the national level, from 1982 through 1994 the troubled-asset ratio for small banks tended to remain below the ratio for large banks. Moreover, the large banks' ratio exhibits relatively wide fluctuations. These data support the impression that banking downturns have tended to take a relatively more severe toll on large banking organizations. And, more importantly, during periods of banking difficulties, when the troubled-asset ratio for large banks rose relatively to the ratio for small banks, declines in small-bank market share slowed or stabilized. It appears that large banks' relatively severe financial struggles mitigated the downward trend in the small-bank market share. The relationship between banking difficulties and small-bank market share observed at the national level is even more pronounced at the regional level.

The article concludes that although the market share of small banks might continue to decline, the relative stability of their financial performance indicates that they should continue to prosper and grow along with the larger organizations in a dynamic banking economy. *Financial Industry Issues, Federal Reserve Bank of Dallas, Second Quarter 1995.*

Bank Card Delinquencies Rise

According to the American Bankers Association, 3.53 percent of credit-card accounts were past due for two or more months during the first quarter of 1996, the highest delinquency rate in 15 years, and preliminary second-quarter figures show a continuing problem. According to preliminary results of an OCC survey of large national banks, banks are responding by tightening credit-card criteria. *BBR, p. 1073, 6/17/96; WSJ, 7/24/96.*

Derivatives Record Set

The OCC reported that banks engaged in $17.85 trillion in derivative activity during the first quarter of 1996, a record level. Trading revenues were approximately $2 billion, and credit exposure declined $7 billion in the quarter. The notional amount of derivatives rose $987 billion during the quarter. Derivative activity continued to be concentrated in the largest banks. *OCC News Release, NR96-67, 6/10/96.*

ABA Survey

According to the 1995 Retail Banking Survey Report, a survey of 180 banks conducted by the American Bankers Association, the total number of bank branches grew by over 1,200 in 1994. Only banks with assets of $1 billion or more registered a decrease in the number of branches per bank. The survey also reported a significant increase in electronic banking services by small and mid-size banks, with six percent of banks with less than $300 million in assets offering such services in 1994, compared to three percent a year earlier. *Northwest Financial Review, p. 6, 1/27/96.*

RECENT ARTICLES AND STUDIES Retail Banking Will Restructure

The study addresses the key factors, from a global perspective, behind changes observed in retail banking that foretell extensive restructuring of the industry. While many studies have concluded that banking economies of scale eventually reach limits, this report argues that retail banks will increasingly be susceptible to scale economies in the future. These banks currently experience scale economies in some activities, such as credit-card processing, check processing, consumer-loan processing and statement preparation. They are subject to diseconomies in numerous other activities, for example, the banks' management costs as a percentage of income appear to rise as their branch networks increase in size. Also, unit management costs rise with increases in their different types of products, and given that the numbers of products offered by banks in many countries have been growing rapidly, management costs have been rising disproportionately from this source.

The report draws comparisons between the future of retail banking and other industries, notably the airlines and communications industries, in which in many cases the activities that formerly were carried out by a single provider have been disaggregated to numerous different providers. These disaggregated activities are increasingly being performed in quasi-autonomous divisions of single companies, or by independent subcontractors. The report predicts similar trends in the retail banking industry.

Under the scenario for the traditional retail bank foreseen here, these institutions will take on more of the appearance of a cluster of businesses, in which the holding company makes "portfolio" type decisions on such issues as whether to enter a new product area, close down a business, or outsource. The new alignment of activities is seen in the future role of branches. Reduced greatly in numbers, they will cease their role as "minibanks," and will be used mainly as gateway sales and counseling centers for upscale or high-net-worth customers. They will support product cross-selling to that minority of customers for which extensive cross-selling can be profitable. *The Future of Retail Banking, A Global Perspective, Deloitte Touche Tohmatsu International, 1995.*

Changing Banking Activities and Regulatory Policies

This article by F. R. Edwards and F. S. Mishkin discusses how banks have shifted from their "traditional" activities and more into off-balance-sheet operations, and the implications for financial stability and regulatory policies. Evidence of the decline in traditional banking is found in the shrinkage in commercial banks' share of funds provided to nonfinancial borrowers, from 35 percent in 1974 to 22 percent at present, as well as the decline in their share of total financial intermediary assets from approximately 40 percent in 1960-1980 to below 30 percent at year-end 1994.

Banks have experienced growing competition that has diminished their cost advantage in acquiring funds, and also has undercut their position in loan markets. They have adjusted to the intensified market competition in part through attempting to maintain their traditional lending activities, but in more-risky types of lending. Examples include a higher percentage of their funds going into commercial real-estate loans, and increased lending for corporate takeovers and leveraged buyouts. As a result, banks' loan-loss provisions relative to assets rose substantially in the 1980s, peaking in 1987, and even in the strong economy of 1994 had declined only to the level of the worst years of the 1970s. A second way banks have sought to maintain profit levels is through new, off-balance-sheet activities that are more profitable than traditional activities.

The risk implications of banks' derivatives activities are examined in this article. Large banks, in particular, have moved aggressively to become worldwide dealers in over-the-counter derivatives, such as swaps. Overall, the authors do not see the risks from derivatives as so different from the other risks in banking as to render inadequate the supervisory policies and procedures that are available. Finally, banks should inform the public of their risks from trading activities, both derivatives and on-balance-sheet activities, and their ability to manage those risks. Reference is made to a discussion paper issued in 1994 by a committee of the G-10 Central Banks which recommended that estimates of financial risk generated by firms' own internal risk-management systems be adapted for public disclosure purposes. *"The Decline of Traditional Banking: Implications For Financial Stability and Regulatory Policy," Economic Policy Review, Federal Reserve Bank of New York, July 1995, pp. 27-45.*

Multi-Office Bank Lending to Small Business

With federal legislation having been enacted in the fall of 1994 authorizing full interstate banking, William R. Keeton examines the relationship between multi-office banking and small-business lending in the Tenth Federal Reserve District. This District includes: Colorado, Kansas, Missouri, Nebraska, New Mexico, Oklahoma, and Wyoming. There are several suggested reasons why large multi-office banks might lend less to small businesses than other banks. First, they do not have to rely as heavily on small borrowers to achieve a desired level and composition of commercial lending. In addition, there are structural factors, such as the fact that large multi-office organizations tend to give loan officers less autonomy than their counterparts have in smaller banks and are required to follow more rigid rules in lending, this suggesting fewer loans being granted to small businesses. From another viewpoint, multi-office banks might make more small-business loans because their greater diversification and access to open-market borrowing enable these institutions to invest more of their funds in loans, in the aggregate and to small businesses, and less in safe, liquid investments such as government securities. Also, while previously existing restrictions on geographic expansion may have confined larger banks mainly to urban areas and making large loans, the relaxation of these limits on expansion will result in these institutions entering more of the smaller, rural markets and expanding their small-business lending.

A study of the Tenth District is of interest because these states have recently lessened their geographic restrictions on bank expansion. Since the mid-1980s all seven states have allowed statewide branching, and also they have laws allowing entry in some form by out-of-state holding companies. Because loan data are not available by branch, the impact of branching on small-business lending is examined by comparing the aggregate loan-deposit ratio of the bank with the average loan-deposit ratio of unit banks comparable to the branches. The data indicate that a moderate degree of branching does not, but a high degree of branching does, reduce small-business lending. In respect to the multi-bank holding companies, the lead banks of in-state firms tend to lend the same percent of deposits as comparable independent banks, but the other banks in in-state and out-of-state companies lend a smaller percent of deposits than their peers, and the differences are greater for banks in out-of-state companies. There are, it is noted, numerous individual bank exceptions to these aggregate patterns.

The overall results of the analysis confirm the conclusions of earlier surveys that multi-office banks tend to lend less to small businesses than other banks. This finding does not suggest, however, that multi-office banking should be curtailed. The lending gap may, after a temporary period, be filled by other banks, and also, any disadvantages may be outweighed by benefits. For example, there is substantial evidence that multi-office banking improves service to depositors and increases competition in local markets. Multi-office banking also makes banks less vulnerable to downturns in the local economy by helping them diversify their loan portfolios. The article suggests, instead, that regulators should follow policies to promote competition by ensuring that multi-office banks do not dominate local markets by absorbing smaller banks, and they should continue progress in reducing regulatory burden, which tends to hurt small banks more than large banks. *Economic Review, Federal Reserve Bank of Kansas City, Second Quarter 1995, pp. 45-57.*

Banks' Disclosure of Derivatives Activities

Banks' derivatives activities have become more apparent as institutions are disclosing more information needed by the public and regulators to make better judgments about companies' activities in this area, according to this study by FRB staff of the 1993 and 1994 annual reports of the top ten U.S. bank dealers in derivatives. The article summarizes the accounting standards and recommendations of industry groups and regulators, and reviews the improvements in qualitative and quantitative disclosures since 1993. Approximately 600 banks were involved in derivatives as of March 31, 1995, though the top 15 banks held more than 95 percent of the derivatives contracts of the banking industry.

In 1994, banks expanded their managements' discussion and analysis of their derivatives activities and provided more quantitative information about these activities than in 1993. The experimentation encouraged by the FASB, regulators, and industry groups is reflected in the diversity of methods used by the top ten banks in presenting information about their derivatives activities. Further improvements in disclosure should be anticipated, including more extensive coordination in this area with national supervisors from other countries. *Federal Reserve Bulletin, 9/95, pp. 817-831.*