Depositor protection and monetary stability can depend on many factors other than the deposit activities of banks. Few of the assets backing bank deposits, for instance, can be considered riskless, and virtually all bank operations entail some potential exposure to loss. In addition, since a notable portion of bank deposits are available on demand, bank liquidity can be an important factor in maintaining depositor confidence. Given these complexities, it is not too surprising that several different approaches are commonly used to protect depositors. These include restrictions on bank risk taking, a deposit insurance system funded through premiums paid by banks, and the federal government’s assumption of overall responsibility for monetary stability and depositor protection.

Historically, much of the regulatory effort in the United States has been directed toward controlling the overall risk that banks incur. Banking regulators first sought to restrict bank risk taking as a means of limiting individual bank failures and depositor losses, as well as preventing banking panics. With the advent of deposit insurance, control of banking risks also became a way of limiting claims on the deposit insurance fund and thus making deposit insurance a workable system. Some of the methods now used by bank regulators to control banking risks are bank capital requirements, restrictions on the type and quality of bank securities holdings, periodic examinations of loan quality and other banking factors, limitations on the activities that banks and their employees can pursue, and supervisory enforcement actions to control risk taking at problem institutions.
These efforts to control banking risk are an essential element in today’s banking system and in the protection of depositors. Such controls must be sufficient to limit bank risk taking to a level consistent with depositor interests, overall financial stability, and the continued operation of the deposit insurance system. At the same time, though, this regulatory approach must not be too restrictive if banks are to meet the needs of their customers, compete effectively with other financial institutions, and adapt to a changing financial system. Banks, in fact, cannot avoid taking risks in their everyday operations. They must design services in anticipation of both customer needs and economic trends, make decisions on the creditworthiness of borrowers and their ability to repay debts in the future, and enter into many complex financial transactions. As a result, regulatory controls on bank risk taking must establish prudential bounds on banking activities without needlessly restricting normal banking functions.

Federal deposit insurance provides an additional means of protecting depositors. By separating the fate of depositors from that of their banks, deposit insurance has prevented panic withdrawals and widespread banking collapses. It has also created a way to resolve serious banking problems without adversely affecting bank customers or other banks in the area. In many cases, for instance, bank regulators have been successful in finding buyers or merger partners for failing banks, thus preserving banking service to communities and maintaining confidence in the banking system. Deposit insurance, though, has not been without costs—either in terms of the potential exposure it places on the federal government and taxpayers or the perverse incentives it may create by limiting the need for depositors to pick the safest banks.

A final link in the system of depositor protection is the federal government itself. Economic and monetary stabilization policies have helped to avoid any repeat of the economic collapse of the 1920s and 1930s. Furthermore, the implicit federal backing to the
The deposit insurance system has given depositors an assurance of safety, even in the event of a crisis that might exhaust the insurance fund.\(^1\)

In reviewing bank regulation for depositor protection, this chapter focuses first on the activities in a bank that influence the risk of its operations and the exposure faced by depositors or by insurers of deposit safety. These activities are examined with regard to the specific regulations and guidelines imposed to protect depositors and the supervisory methods adopted to ensure regulatory compliance and assess risk. The second part of the chapter discusses supervisory procedures from an operational standpoint. It also covers the methodology used to combine all of the individual risk factors at a bank into an overall assessment of the bank and the safety of its depositors.

**Banking Factors and Regulations Affecting Depositor Safety**

The role bank regulators assume in protecting and insuring depositors is similar to the position any creditor or insurer takes in protecting his or her interests. A bank regulator has much the same concerns as any creditor and takes much the same steps. Creditors try, for example, to limit a borrower’s risk or charge more for higher risks. Creditors also try to limit their own exposure and increase a borrower’s stake in the transaction by securing collateral for the loans they make and by limiting a borrower’s indebtedness relative to his or her income and resources. A creditor may also want to impose restrictions on a borrower’s activities and use of assets and undertake periodic investigations of the borrower’s operations.

Bank regulators take many similar steps in an effort to control

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\(^1\) A 1982 concurrent resolution of Congress reaffirmed that insured deposits are backed by the full faith and credit of the United States. This full faith and credit backing was also included in Title IX of the Competitive Equality Banking Act of 1987 and in the insurance sign that savings associations must display in accordance with the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.
banking risks and thereby protect depositors and ensure financial stability. Banks, for instance, are restricted to certain activities and must maintain adequate capital relative to asset and operational risks. They are also expected to maintain enough low-risk liquid securities to cover normal fluctuations in deposits. They are regularly examined, and bank supervisors will impose tighter restrictions on banks if their condition declines.

Several other regulations, such as bank entry restrictions and supervisory review of ownership and management changes, affect depositors and banking risks. However, since these regulations have a substantial effect on banking competition and efficiency, they are discussed in the next chapter.

**General lending and investment restrictions**

In our fractional reserve banking system, loans and securities represent the major assets supporting a bank’s deposit liabilities. For that reason, depositor protection and the stability of the banking system are closely tied to the quality and liquidity of these two asset items, and a number of regulatory and supervisory standards address the types and quality of assets banks can hold. This policy is implemented in two ways. First, state and federal statutes define permissible banking assets. Second, regular examinations and other supervisory procedures are used both to check compliance with the statutes and to review a bank’s loan and investment policies and the quality of its assets.

There are relatively few statutory restrictions which limit the specific types of loans a bank can make. In this respect, banks have been somewhat unique among financial institutions in their role as a lender for all purposes and to many kinds of customers. Although bankers must follow any state and federal credit statutes applying to lenders in general, only a few provisions restrict the types of loans they can make. Instead, bank credit decisions are based primarily on business factors and the need to maintain a
secure asset base and a sound reputation in order to support bank deposits. Periodic loan reviews by internal committees, independent auditors, and bank supervisors provide an additional check on bank credit quality.

Real estate loan restrictions — Historically, one of the few areas of bank lending that has drawn special legislative and regulatory attention is real estate lending. Restrictions on bank real estate lending have varied from an outright prohibition on such lending in the early days of the national banking system to relatively minor restraints in some recent periods. Limits on real estate lending were implemented originally to keep banks from carrying a concentration of long-term loans that could not be readily liquidated to meet depositor needs or quell a banking crisis. These limits further sought to control the credit and interest rate risks inherent in many aspects of real estate lending. Regulations, though, were gradually eased as banking stability increased and a better secondary market for mortgage loans developed. Public interest in the promotion of home construction and ownership also played a part in this change.

Current real estate lending regulations attempt to limit excessively risky lending practices, while giving bankers flexibility to meet the needs of most borrowers. These regulations are also a response to real estate problems over the last four decades and were mandated by section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991.2

The real estate provisions, as implemented by the three federal banking agencies and the Office of Thrift Supervision, first require each insured depository institution to establish and maintain comprehensive written policies for real estate lending. In these policies, banks are required to address a number of considerations. The policies, for instance, should establish standards for loan portfolio

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2 For national banks, state nonmember banks, and state member banks, the real estate lending regulations can be found in 12 CFR 34 Subpart D, 12 CFR 365, and 12 CFR 208 Subpart E, respectively, and the Interagency Guidelines for Real Estate Lending Policies are contained in the appendices to these parts.
diversification, with limits on the volume of lending in various real estate categories and within a geographic market.

Other policy provisions should set prudent underwriting standards for a bank, including the specific criteria that will be used to judge creditworthiness. These provisions should also indicate maximum loan maturities, acceptable amortization schedules for each type of loan, and the maximum loan amount that generally can be extended in relation to the market value of the property. Bank real estate lending policies should further incorporate loan administration procedures that encompass the documentation of a borrower’s condition, periodic evaluations of collateral, and all steps from closing the loan through payoff or collection on it. A final policy topic should be the requirements the bank has in place for monitoring compliance with its real estate lending policies.

In addition, federal regulations provide specific guidance on the appropriate level of real estate lending in relation to the value of the property that is held as collateral. While institutions are free to establish their own internal loan-to-value limits for real estate lending, these limits should not exceed the supervisory limits which are shown in Table 3. Banks, however, may make or purchase real estate loans that exceed the supervisory loan-to-value guidelines, provided this lending is supported by individual credit factors. The aggregate amount of such loans must be reported regularly to the bank’s board of directors, and this amount must not exceed 100 percent of a bank’s total capital, with a 30 percent limit for non-residential lending. The loan-to-value limits can also be waived for certain loans that are guaranteed or insured by the U.S. Government, its agencies, or state or local governments. Other exceptions include certain loan renewals and restructurings and loans in which an interest in real property is taken as collateral through “an abundance of caution.”

Two other aspects of real estate lending — the use of property appraisals and the pricing of adjustable-rate loans — have become subject to federal regulation. Real estate appraisal standards, as
mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, seek to ensure that bank real estate lending decisions are supported by independent evaluations of the property to be held as security. This act and the implementing regulations consequently require all banks to obtain a written appraisal from a state certified or licensed appraiser in connection with certain real estate loans and other financial transactions involving real property.

Several types of transactions are exempt from the appraisal requirements, most notably those that are unlikely to threaten the soundness of a bank and those that rely primarily on other sources

<table>
<thead>
<tr>
<th>Real Estate Loan Category</th>
<th>Loan-to-Value Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Raw Land</td>
<td>65 percent</td>
</tr>
<tr>
<td>Land Development</td>
<td>75 percent</td>
</tr>
<tr>
<td>Construction:</td>
<td></td>
</tr>
<tr>
<td>Commercial Multifamily **</td>
<td>80 percent</td>
</tr>
<tr>
<td>and other Nonresidential</td>
<td></td>
</tr>
<tr>
<td>1-to-4 Family Residential</td>
<td>85 percent</td>
</tr>
<tr>
<td>Improved Property</td>
<td>85 percent</td>
</tr>
<tr>
<td>Owner-occupied 1-to-4 Family</td>
<td>***</td>
</tr>
<tr>
<td>and Home Equity</td>
<td></td>
</tr>
</tbody>
</table>

* Institutions should establish their own internal loan-to-value limits for real estate loans. These limits should not exceed the limits in this table.

** Multifamily construction includes condominiums and cooperatives.

*** A loan-to-value limit has not been established for permanent mortgage or home equity loans on owner-occupied, 1-to-4 family residential property. However, for any such loan with a loan-to-value ratio that equals or exceeds 90 percent at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.
of repayment. Such exemptions include real estate loans and transactions with a value of $250,000 or less, liens taken as collateral in an abundance of caution, and transactions involving real property where a bank either takes no security interest or takes an interest for purposes other than the property's value. Another exempt transaction is business loans of $1 million or less in which the primary source of repayment is not derived from renting or selling real estate. Also exempt are real estate loans and mortgage-backed securities that are adequately supported by previous appraisals or by U.S. Government agency guarantees or underwriting requirements.

Standards for pricing adjustable-rate loans at national banks have been in place since 1981, when the Comptroller of the Currency first authorized national banks to offer such loans. Although the initial regulations required national banks to tie their rate adjustments to a selected group of indexes, the Comptroller now allows national banks to use any index beyond their own control that a borrower can readily verify. The Comptroller has also eliminated earlier restrictions on the size and frequency of interest rate adjustments and eased amortization requirements. In addition to these pricing parameters, Congress passed legislation in 1987 requiring mortgage lenders to specify a maximum interest rate or cap that could be charged on each adjustable-rate loan.

Apart from these federal regulations, many states impose their own real estate lending restrictions on state banks. Some states have requirements for loan-to-value ratios and for adjustable-rate mortgages. A number of states have usury ceilings on mortgage loans granted within the state. In addition, state banks, under the Garn-St Germain Act of 1982, may make or purchase any alter-

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3 For these transactions, a less formal evaluation of the real estate can be used to provide an estimate of its value.

4 The Depository Institutions Deregulation and Monetary Control Act of 1980 preempted all state usury ceilings on residential mortgage loans, but states were given a three-year period during which they could reintroduce usury ceilings.
native mortgages that would be permissible for national banks, provided a state has not passed laws to prohibit such lending.

Margin requirements on securities loans — Another statutory lending restriction is margin requirements on securities loans. Margin requirements are set by the Board of Governors of the Federal Reserve System and grew out of the 1929 stock market collapse and the alleged role of banks and other lenders in financing the stock speculation of the 1920s. By setting margin requirements, the Board limits the credit banks and other lenders can extend when securities are held as collateral for a loan. This limit, however, only applies if the loan is to purchase or carry margin stocks and if these or other margin stocks are the securities held as collateral. Margin stocks are defined as stocks registered on the national exchanges, OTC stocks that qualify for trading in the National Market System (NMS securities), most mutual funds, debt securities convertible into a margin stock, and warrants or rights to purchase margin stocks.

The loan limit is expressed as a percentage of the market value of the collateral at the time the credit was extended. The percentage difference between the market value of the collateral (100 percent) and this maximum loan value is termed the margin requirement. For example, a margin requirement of 60 percent would mean that an investor could borrow only 40 percent of the market value of the collateral at the time the loan was originated.

The Board’s authority to set specific margin requirements and issue any necessary regulations arises from the Securities Exchange Act of 1934. Margin requirements on stock-secured credit extensions by securities brokers and dealers are implemented through Federal Reserve Regulation T. Similar credit extensions by banks and other lenders are governed by Regulation U, and Regulation X applies margin requirements to credit obtained outside of the

\[ 5 \text{ 15 U.S.C. §78.} \]
United States. The current margin requirement of 50 percent has been in effect since January 3, 1974.

Certain aspects of margin requirements have been debated for a number of years, including their overall role in financial markets and the desirability of eliminating differences in margin requirements across securities, options, and futures markets. In particular, a 1984 Federal Reserve staff study cast some doubt over the need to maintain high margin requirements to achieve a balanced distribution of credit, prevent stock speculation and excessive price fluctuations, and protect investors or brokers against assuming inappropriate risks. This study found that margin credit supported only a small portion of all stock holdings and that markets handling many of the new financial instruments operated reasonably well with less extensive regulation of margin credit. The Federal Reserve study and other studies of margin requirements provide some support for a more evenhanded approach across various financial instruments and for the restriction of high margin requirements to emergency situations. As other markets with lower margin restrictions continue to develop and expand, the role and use of securities margin requirements will likely receive further attention.

Selective credit controls — In addition to margin and real estate loan restrictions, banks have sometimes been subject to selective credit controls administered by the Federal Reserve. Consumer and real estate credit controls have typically been adopted during wartime as a means of channeling credit and materials toward war-related production. Credit controls have been imposed at other times to control inflationary pressures. In several cases, credit controls were imposed on more than just bank lenders. Examples of periods when credit controls were used are during World War II, the Korean War, and the spring and summer of 1980.

The benefits of credit controls, however, have been questioned

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by many, and these controls have been difficult to implement in an effective and impartial manner. As a result, little support exists for using such constraints in situations other than the most urgent.

Examination and supervisory influence on credit quality —

The major supervisory influence on the types, maturity, and quality of bank loans is through examination and supervision rather than through lending statutes. In a bank examination, bank loan portfolios are evaluated primarily with regard to their overall quality and their risk under different economic conditions. Since the majority of bank assets are typically loans, assessments of loan quality are central to an examination and to a determination of the protection provided bank depositors and the deposit insurance fund.

The first step in a supervisory loan evaluation is an analysis of a bank’s formal loan policies and its adherence to these policies. A formal policy helps establish a bank’s lending objectives, and without such policy guidance, lending officers would be more likely to make inappropriate or excessively risky loans. Bank lending policies may set general guidelines for bank liquidity, total loan volume relative to bank assets and capital, and the allocation of funds to different types of borrowers. Guidelines may also be included for credit approval criteria, collateral, documentation, repayment terms, and each officer’s loan limits and responsibilities.

Supervisory authorities look next at the quality of individual loans, giving their greatest attention to the larger lines of credit. Loan quality is judged by the repayment ability of the bank’s credit customers. This credit analysis includes a review of such significant factors as a borrower’s net worth, cash flow, pledged collateral, payment history, and earnings prospects. Credits determined to have excessive risks and questionable collection characteristics are then classified by examiners into one of three categories and called to the attention of bank management and directors:

*Substandard* credits involve more than normal risk due to performance, financial condition, insufficient collat-
eral, or other factors, and deserve more than normal servicing and supervision.

*Doubtful* credits include those that have a probable loss, the amount of which cannot be readily determined.

*Loss* credits are regarded as uncollectible.

In addition, examiners may list an asset as *special mention* when it has potential weaknesses that deserve management’s close attention. Such weaknesses could further affect repayment if left uncorrected.

The three classification categories are important in determining the condition of the loan portfolio, because they reflect not only the volume but also the severity of criticized loans. In the bank rating system used by the three federal regulators, the total amount of classifications in each category is considered in assessing the quality of a bank’s loans and assets and the adequacy of its capital and loan loss reserves. The Federal Reserve, for example, calculates a weighted classification figure by taking 20 percent of substandard, 50 percent of doubtful, and all of the loss classifications. This number is then compared to a bank’s capital, and the resulting ratio serves as a measure of asset risk exposure in a bank.

Although banks cannot avoid some unforeseen loan problems and losses, bankers are expected to limit such losses by controlling the amount of risk they assume. Thus, in analyzing credit risks, examiners also look at whether bankers have avoided such credits as speculative loans, loans to borrowers of undesirable character, working capital loans to highly leveraged businesses, and unsecured loans that cannot be supported by a borrower’s cash flow and tangible net worth. Bankers should further avoid loans to businesses where the bank’s lending effectively represents an equity investment that should more appropriately be provided by
investors. In addition, bank supervisors look at the maturity structure of a bank's loan portfolio and note any concentration of long-term, fixed-rate loans. Such loans could leave banks vulnerable to changes in interest rates and inflation, much as occurred with the thrift industry in the late 1970s and early 1980s.

Bank supervisors also evaluate bankers on how well they have avoided loan concentrations, such as to an individual and related interests or to a single industry, product line, or type of collateral. Risk diversification is a fundamental tenet of banking and finance, serving to insulate banks from downturns in any one specific area. Adequate diversification may not always be possible, however, because some banks serve a very narrow base of loan customers. A bank may be located in a town dominated by a single employer, for example, or in an area dependent on a single industry, such as agriculture. In these instances, supervisors might expect bank managers to maintain higher credit and collateral standards to offset any loan concentration risks. Of more concern to supervisors is a failure by bank management to take advantage of opportunities to diversify when such opportunities exist.

The effect of supervisory credit evaluation on bank lending activities is difficult to judge overall. Ideally, these credit reviews represent a cooperative sharing of information among bankers and examiners, and an important role of examinations should be to provide a bank's management, board of directors, and its supervisory authorities with an independent evaluation of the bank's lending function. While most bankers would naturally avoid the types of loans and loan policies that examiners judge too risky, examinations may help to encourage some bankers to adopt sounder lending policies. Periodic loan examinations may also give bankers an added incentive to take timely action on problem credits. Finally, supervisory loan reviews help enforce the statutes and regulations on credit extensions, ensure that loan documentation is sufficient for an adequate credit analysis, and give supervisors a
Limit on loans to a single borrower — Bank lending decisions are affected not only by supervisory reviews and statutes relating to specific types of loans, but also by several general credit regulations. Federal and state laws, for example, limit the size of loans that can be made to a single borrower. The intent of these laws is to spread the risks that a bank assumes and not leave the bank vulnerable to difficulties encountered by a few major borrowers.

At national banks, this statutory lending limit is 15 percent of the bank’s unimpaired capital and surplus for loans that are not fully secured. Another 10 percent of unimpaired capital and surplus may be lent if this additional amount is fully secured by readily marketable collateral. In its regulations on lending limits, the OCC has defined capital and surplus to be a bank’s Tier 1 and Tier 2 capital under the risk-based capital requirements, plus the balance of the allowance for loan and lease losses not included in Tier 2 capital.

State bank lending limits cannot be summarized easily. There is considerable variation across states in the limits for unsecured loans, as there is in the exceptions made for collateralized credits and the definition of single borrowers. Many state laws and regulations are aimed at achieving parity with the national bank provisions, but a significant number of states have authorized higher lending limits for state banks. Compliance with legal lending limits for both state and national banks is reviewed during examinations of banks and their loan portfolios.

These lending limits for national banks and state banks generally apply to any direct and indirect obligations of a borrower, including any partnership interests. For corporations, the obligations of a parent company are most often combined with those of other obligations.

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7 Revised Statutes, sec. 5200; 12 U.S.C. §84, and 12 CFR 32. A few exceptions to these lending limits exist for loans secured by special types of collateral. For information on the components of Tier 1 and Tier 2 capital, see pages 86–88 of this book.
any majority-owned or majority-controlled subsidiaries to determine compliance with legal lending limits. Violations of this statute can often be attributed to a bank’s failure to aggregate all the credits extended directly to a borrower together with his or her liability as endorser or guarantor on related interests.

Bank supervisors consider excessive lending to a single borrower a serious matter requiring immediate correction. Such lending provides inadequate diversification and could result in substantial losses in bank capital if a few large borrowers were to default on their obligations. In fact, a notable number of bank and savings and loan association failures over the last few decades have been traced to fraudulent borrowers using a variety of related interests and corporate ruses to obtain excessive credit extensions. While several of these failures were the result of insider dealings, many large loan losses have involved honest bankers who failed to keep track of each borrower’s related interests and total indebtedness.

*Loans to insiders* — Another credit restriction applies to insider loans. The basic reason for insider lending restrictions is to prevent those in charge of a bank from using their positions to obtain credit on preferential terms and outside normal credit underwriting standards. Such restrictions help ensure that a bank’s lending is in the best interest of its depositors and community.

Loans by member banks of the Federal Reserve System to their executive officers became subject to close supervision after the banking crisis of the 1930s. In 1978, additional insider lending restrictions were extended to the executive officers, directors, and principal shareholders of all insured banks. Also, borrowings by any of these parties from correspondent banks became subject to a number of standards. Several of the insider lending restrictions were further tightened by the Federal Deposit Insurance Corporation Improvement Act of 1991.

Insider loan restrictions on member banks and their subsidiaries are covered in sections 22(g) and 22(h) of the Federal Reserve Act
and implemented through Regulation O. Under Regulation O, extensions of credit by a member bank to any of its executive officers, directors, or principal shareholders, or to any of their related interests, must be on substantially the same terms, including interest rates and collateral, as comparable transactions with outside parties. These transactions must involve no more than normal credit risk and must also follow credit underwriting procedures that are no less stringent than for other borrowers. Other bank employees and shareholders are not subject to Regulation O.

Any extension of credit to an executive officer, director, or principal shareholder that exceeds a specified amount requires the prior approval of a majority of the entire board of directors of the bank. The banking agencies presently require board approval when an insider loan exceeds the higher of $25,000 or 5 percent of the bank's unimpaired capital and surplus. For purposes of this limit, a loan must be aggregated with other credit extensions to the same individual and all related interests of that person. A loan to an insider would also require board approval if that loan, when aggregated with all loans to that person, exceeds $500,000. The interested party must abstain from any participation, direct or indirect, in the board's deliberation.

Extensions of credit by a member bank to any of its executive officers, directors, or principal shareholders and their related interests must also comply with the same single borrower limit imposed on national banks — 15 percent of the bank's unimpaired capital and surplus for loans not fully secured and an additional 10 percent of unimpaired capital and surplus for loans fully secured by readily

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9 Regulation O and the insider lending statutes define an executive officer as “a person who participates or has authority to participate in major policymaking functions of the company or bank.” A principal shareholder is anyone “that directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote more than 10 percent of any class of voting securities of a member bank or company.”
marketable collateral. In addition, a bank’s total lending to all insiders generally may not exceed its unimpaired capital and surplus.\(^{10}\)

Other Regulation O provisions limit overdrafts by executive officers and directors and impose additional restrictions on borrowing by executive officers. A member bank generally may not pay overdrafts of an executive officer or director, except in accordance with a written, preauthorized, interest-bearing extension of credit or a written, preauthorized transfer of funds from another account. In lending to their executive officers, member banks may extend credit for an officer’s residence or children’s education. Any other loans to an executive officer must not exceed an amount prescribed by the appropriate federal banking agency.\(^{11}\)

Section 18(j)(2) of the Federal Deposit Insurance Act extends insider lending restrictions to nonmember insured banks. Under this section, the provisions summarized above apply “in the same manner and to the same extent as if the nonmember insured bank were a member bank.”

Insider lending restrictions are enforced through reporting requirements and bank examinations. Banks must maintain a record of credit extensions to their executive officers, directors, and principal shareholders. A bank must also report quarterly, in conjunction with the Report of Condition, the total amount of credit extended to its executive officers, directors, principal shareholders, and their related interests.\(^{12}\) A bank is further required to report the number

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\(^{10}\) To help attract directors and avoid restricting credit in small communities, banks with total deposits of less than $100 million may establish an aggregate insider lending limit of up to twice unimpaired capital and surplus. Any bank adopting such a limit must maintain adequate capital and satisfactory supervisory ratings, and its board of directors must adopt a resolution certifying the necessity of a higher limit.

\(^{11}\) Presently, such lending to any executive officer must not exceed the higher of $25,000 or 2.5 percent of the bank’s capital and unimpaired surplus up to a limit of $100,000. These limits do not apply to loans that are fully secured by U.S. Government obligations or by a deposit account at the lending bank.

\(^{12}\) When filing their Reports of Condition, banks must also specify the number of loans made to executive officers since the previous reporting date, the total dollar amount of these loans, and the range of interest rates charged on the loans. This information, however, is not treated as part of the actual Report of Condition.
of such insiders having loans which exceed the lesser of 5 percent of
the bank’s unimpaired capital and surplus or $500,000. The names
of any executive officers and principal shareholders in this group are
to be disclosed to the public upon written request, provided the
loans to a particular individual and related interests exceed $25,000.
Insider lending records and compliance with the regulations are fur-
ther verified during the regular examination of a bank.

In addition to the federal regulations, state banks, both member
and nonmember, must comply with state statutes on lending to
insiders. Several states have laws that closely mirror the federal
statutes. In other states, however, the statutes may vary with regard
to what size of loan must be approved by a bank’s board of directors,
the specific lending limits in relation to bank capital or in actual dol-
lar amounts, the type of insiders included — executive officers,
directors, or principal shareholders, and the extent to which any
related interests of an insider are included in the restrictions.

Apart from the regulations on insiders borrowing from their
own banks, federal restrictions also extend to borrowing from cor-
respondent banks. Under these restrictions, preferential lending
by a bank to the executive officers, directors, or principal share-
holders of another bank is prohibited when there is a correspondent
relationship between the banks. Nor can a correspondent account
be opened if preferential lending already exists between one of the
banks and an executive officer, director, or principal shareholder of
the other bank. Public disclosure requirements on loans from cor-
respondent banks are similar to those on insider loans.

Insider lending restrictions have helped to curb insider abuses
and limit other violations to inadvertent mistakes, such as a failure
to aggregate all loans to an individual. Bankers and regulators,
however, must continue to take a careful look at ownership and
management lending practices. Insider abuses have been a com-

13 These restrictions on borrowing from correspondent banks are contained in 12 U.S.C.
§1972(2).
mon factor in many troubled institutions and are still a significant concern in banking. Studies of failing banks, for instance, have often cited such insider problems as fraud and losses on insider loans as a key factor in the failures. A 1994 U.S. General Accounting Office report noted that insider problems had been found in 65 percent of the bank failures over a two-year period, with these problems representing one of the major reasons for failure in 26 percent of the banks.\(^\text{14}\)

**Acceptable types and maturity distribution of securities** — To limit portfolio risks on investments and provide liquidity, banks are authorized to purchase and hold only certain types of debt securities. Other aspects of a bank’s securities holdings are also of regulatory interest, including the valuation and classification of securities, maturity structure and overall liquidity of the portfolio, and restrictions on holding equity securities.

A member bank cannot hold investment securities of any one obligor totaling more than 10 percent of its unimpaired capital and surplus.\(^\text{15}\) Investment securities are defined as marketable obligations evidencing indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures. The Comptroller of the Currency has also defined investment securities to exclude securities that are predominantly speculative. Under these definitions, member banks are allowed to purchase securities in only the four highest rating grades estab-

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\(^{15}\) The investment securities and corporate stock holdings of national banks are restricted by the *Revised Statutes*, sec. 5136 (12 U.S.C. §24, as implemented by 12 CFR 1). The same statutes are extended to state member banks by 12 U.S.C. §335.
lished by the rating agencies (AAA, AA, A, and BAA) or unrated securities of equivalent quality. The limits on holding securities of any one obligor do not apply to obligations issued or guaranteed by the U.S. Treasury or general obligations of states and political subdivisions. In addition, the Gramm-Leach-Bliley Act of 1999 removes the single obligor limitation for municipal revenue bonds purchased by well-capitalized member banks. Most states also have comparable restrictions on the types of debt securities state banks can hold, although a number of states allow some noninvestment securities to be held.

Accounting standards influence the way in which investment securities at both state and national banks are evaluated for reporting purposes. In 1994, banks were required to adopt certain provisions of the Financial Accounting Standards Board Statement No. 115, which requires securities to be divided into three categories: held-to-maturity, available-for-sale, and trading securities.

Under these standards, only the debt securities that a bank has the positive intent and ability to hold to maturity may be included in its held-to-maturity account. These securities are to be evaluated at their amortized cost for reporting purposes and capital calculations. Trading securities, which are the securities that a bank buys and holds principally for the purpose of selling in the near term, are to be reported at fair value (i.e., market value). In addition, any unrealized appreciation or depreciation in the value of these securities is to be reported on a bank’s income statement and directly reflected in its earnings.

Securities in the available-for-sale category are those that a bank does not intend to trade actively, but also does not plan or have the ability to hold to maturity. While such securities are to be reported at fair value, any appreciation or depreciation in their value will not be reflected in a bank’s reported earnings. Also, the banking agencies have agreed not to incorporate these unrealized gains or losses in risk-based capital calculations, but they will pay close attention to the amount of any unrealized losses.
Apart from these accounting provisions, several special examination rules apply to the classification and valuation of noninvestment grade securities at insured banks. For securities that deteriorate to below investment grade, any depreciation in their market value relative to book value is to be classified by examiners as doubtful, and any remaining book value will be classified as substandard. The depreciation in defaulted securities is generally classified as loss. An exception to these rules, however, may be made for subinvestment-quality municipal general obligations backed by the credit and taxing power of the issuer. The entire amount of any such obligation may be classified substandard as long as it is not in default.

These classifications thus provide an indication of the soundness of a bank’s securities portfolio. Moreover, in computing the net sound capital of a bank, bank regulators deduct from a bank’s reported capital 50 percent of the doubtful classifications and all the loss classifications on securities and loans.

Examiners not only assess the soundness of a bank’s securities portfolio, but also review the portfolio’s maturity structure. This analysis focuses on whether maturities have been managed in a manner that will ensure ready funds for meeting general business fluctuations and will help minimize a bank’s overall exposure to interest rate changes. This regulatory attention further reflects the fact that a bank’s securities portfolio is expected to fulfill a variety of purposes, including acting as a source of liquidity and income and being part of a bank’s interest rate risk management strategy.

Bank authority to hold equity securities has been much more restrictive than for debt securities. For instance, in response to the investment banking problems of the 1920s and early 1930s, federal banking laws were amended to specifically prohibit member banks from purchasing and holding corporate stocks for their own

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accounts. Also, while several states have given their banks limited equity investment powers in recent years, the Federal Deposit Insurance Corporation Improvement Act of 1991 now restricts state banks to the same holdings as national banks except for limited grandfather rights.

As a result of these steps, the stock holdings of banks are generally limited to such things as Federal Reserve bank stock, stock of subsidiary service corporations or bankers banks, qualified housing projects, and stock acquired temporarily as collateral on defaulted loans. The Gramm-Leach-Bliley Act of 1999 further allows national and state banks to invest in financial subsidiaries, which are authorized to conduct a broader range of financial activities than are permissible for banks. To do so, though, a bank and any depository institutions affiliated with it must be well capitalized and well managed and have satisfactory or better CRA ratings.

**Maintenance of adequate capital**

A commercial bank must have enough capital to provide a cushion for absorbing possible loan losses or other problems, funds for its internal needs and expansion, and added security for depositors and the deposit insurance system. In addition, higher capital serves to increase the financial stake that stockholders have in the safe and sound operation of a bank. Consequently, bank regulators view capital as a key element in holding banking risks to an acceptable level.

Capital adequacy determinations, though, have posed problems for bankers and regulators, since capital needs can depend on a wide variety of factors. Some of these factors are a bank's risk profile and the activities it undertakes, its size and access to capital markets, and future and often unforeseen economic and financial conditions. In addition, not all components of capital offer the same benefits and protection to a bank. For example, subordinated debt protects bank depositors, but it differs from equity capital
instruments in that it has a limited life and also places a fixed demand on bank revenues. Another complicating factor is that banks and their customers receive protection from deposit insurance and other elements of the federal safety net, thus potentially weakening and leaving less of a role for the usual market forces in determining bank capital needs. To deal with these complexities, bank supervisors typically assess a bank’s capital in relation to both industry-wide standards and individual banking factors. They also look at a number of different capital components.

Maintaining adequate capital and accurately assessing capital needs have assumed further prominence in the supervision of banks over the past few years. The Federal Deposit Insurance Corporation Improvement Act of 1991 created a new supervisory framework linking enforcement actions closely to the level of capital held by a bank. This system of supervision, commonly known as prompt corrective action, represents an attempt to provide a timely and nondiscretionary triggering mechanism for supervisory actions. Key objectives of such actions are to resolve banking problems at an early stage and at the least possible cost to the bank insurance fund. Under prompt corrective action, for instance, federal banking agencies must institute progressively more severe supervisory responses as a bank’s capital declines. As a result, these prompt corrective action standards have become the primary regulatory influence over bank capital levels.

Another recent factor influencing supervisory policies on capital is the substantial progress that banks are achieving in measuring and controlling their risk exposures. Many banks are using internal credit rating systems, financial models, and other means to allocate capital better and to assess their overall capital needs. In addition, financial innovation is leading to better means for controlling risk exposures — most notably through more sophisticated hedging practices, securitized assets, swaps, credit derivatives, and other forms of derivatives. This progress in measuring and controlling risk is beginning to influence how supervisors assess
bank capital adequacy and will undoubtedly play a key role in future capital standards.

Capital measures — Under the 1991 legislation, the federal banking agencies must assign each bank to one of five possible capital categories: (1) well-capitalized; (2) adequately capitalized; (3) undercapitalized; (4) significantly undercapitalized; and (5) critically undercapitalized.17 These categories provide the basic framework for prompt corrective action and determine whether a bank will be subject to enforcement actions. Banks that are in the top two capital categories will not be subject to any prompt corrective action enforcement steps. On the other hand, banks that fall below these categories will face a set of mandatory enforcement actions that may also be supplemented by other actions at the supervisor’s discretion.

To assign banks to the capital categories, regulators look at three basic capital ratios: total capital to risk-weighted assets (Total risk-based capital ratio), Tier 1 capital to risk-weighted assets (Tier 1 risk-based capital ratio), and Tier 1 capital to total average assets (Leverage ratio).18 These three standards attempt to capture different aspects and components of a bank’s capital holdings, while relating such holdings more directly to the bank’s risk profile. The level of capital a bank holds under each of these ratios will determine the particular capital category assigned to this bank. In addition, the agencies follow a tangible equity capital-to-total average assets ratio (Tier 1 capital plus cumulative perpetual preferred stock in relation to total average assets) for determining whether a bank is in the critically undercapitalized category.

In constructing these capital ratios, bank supervisors must first divide a bank’s capital into two basic components: Tier 1 or core

17 The prompt corrective action provisions are contained in section 131 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. §1831o).

18 These capital ratios and their individual components primarily reflect a 1988 agreement on a common risk-based capital framework that the federal banking agencies reached with the bank regulatory authorities of 11 other major countries through the Basel Committee on Banking Supervision. This international agreement has subsequently been adopted by over 100 countries.
capital and Tier 2 or supplementary capital. Tier 1 capital represents the most permanent form of capital and the highest quality of capital that is available to absorb losses. The elements in Tier 2 capital, while still providing protection against losses, may be of a limited life and carry an interest obligation or other characteristics of debt instruments.

The components of Tier 1 or core capital consist of:

- common stockholders' equity
- noncumulative perpetual preferred stock
- minority interests in the equity accounts of consolidated subsidiaries

Goodwill and certain other intangible assets are deducted from Tier 1 capital.\(^{19}\) Based on these components and exclusions, Tier 1 capital thus represents the most stable and readily available form of capital for supporting a bank's operations.

Tier 2 or supplementary capital includes:

- the allowance for loan and lease losses (up to a maximum of 1.25 percent of risk-weighted assets)
- cumulative perpetual or long-term preferred stock
- hybrid capital instruments and mandatory convertible debt securities
- subordinated debt and intermediate-term preferred stock
- unrealized holding gains on equity securities

The amount of subordinated debt and intermediate-term preferred stock that a bank counts as supplemental capital cannot be more than 50 percent of its Tier 1 capital. In addition, these two

\(^{19}\) Any items that are deducted from capital are also deducted from risk-weighted assets in computing risk-based capital ratios. Intangible assets that reflect purchased mortgage servicing rights and purchased credit card relationships, however, may be included in Tier 1 capital provided they meet certain criteria regarding their value.
components and any other limited-life capital instruments are discounted in Tier 2 computations as they approach maturity. This discount factor is one-fifth of the original amount of the instrument for each additional year during the instrument’s last five years of maturity (20 percent discount for remaining maturities of four to five years, 40 percent discount for three to four years to maturity, …, and 100 percent discount for less than a year to maturity).

For the prompt corrective action standards, a bank’s Tier 1 and Tier 2 capital are added together to make up the total capital component in the total risk-based capital ratio. If a bank has investments in unconsolidated banking and finance subsidiaries or has reciprocal holdings of capital instruments of another bank, these items must be deducted from this total capital measure.

Tier 1 or core capital is used separately in constructing the Tier 1 risk-based capital ratio and the leverage ratio. The tangible equity ratio is calculated using Tier 1 capital plus the amount of outstanding cumulative perpetual preferred stock. Both the leverage and tangible equity ratios use total bank assets as their base, which is defined as the quarterly average of total assets reported in a bank’s Report of Condition.

For the total and Tier 1 risk-based capital ratios, the capital components are compared to a risk-weighted assets base, thereby providing a closer link between a bank’s capital needs and its risk profile. In computing this asset base, the capital standards assign bank assets and off-balance sheet items to one of four general categories of credit risk, as determined by such risk factors as the type of obligor on each asset and the existence of any collateral or guarantees. Each category receives its own risk weight — either 0, 20, 50, or 100 percent — and the greater weights are applied to those items generally thought to pose more risk to a bank. The dollar amount of items a bank has in each risk category is then multiplied by the appropriate risk weight, and the resulting figures are added across the categories to derive the bank’s overall risk-weighted capital.

20 If a bank has investments in unconsolidated banking and finance subsidiaries or has reciprocal holdings of capital instruments of another bank, these items must be deducted from this total capital measure.

21 Like Tier 1 capital, the tangible equity measure includes the value of certain purchased mortgage servicing rights, while excluding goodwill and most other intangible assets.
Table 4
Summary of Risk Weights and Major Assets in Each Risk Category

Category 1 – Zero Percent Weight
Cash
Balances due from Federal Reserve Banks and claims on central banks in other OECD countries
U.S. Treasury and Government agency securities and claims on or unconditionally guaranteed by OECD central governments
Federal Reserve stock
Claims collateralized by cash on deposit or by securities issued or guaranteed by OECD central governments or U.S. Government agencies

Category 2 – 20 Percent Weight
Cash items in the process of collection
All claims on or guaranteed by U.S. depository institutions and banks in OECD countries
General obligation bonds of state and local governments
Portions of claims secured by U.S. Government agency securities or OECD central government obligations that do not qualify for a zero percent weight
Loans or other claims conditionally guaranteed by the U.S. Government
Securities and other claims on U.S. Government-sponsored agencies

Category 3 – 50 Percent Weight
Loans secured by first liens on 1-to-4 family residential property and certain multifamily residential properties
Certain privately issued mortgage-backed securities
Revenue bonds of state and local governments

Category 4 – 100 Percent Weight
All loans and other claims on private obligors not placed in a lower risk category
Bank premises, fixed assets, and other real estate owned
Industrial development revenue bonds
Intangible assets and investment in unconsolidated subsidiaries, provided they are not deducted from capital

1 The group of countries associated with the Organization for Economic Cooperation and Development (OECD) includes the United States and 24 other major industrial countries.
assets measure. As a result, higher risk assets will make a more prominent contribution to this risk-weighted base and thus will require greater capital backing.

Table 4 shows the risk weights and major items in each of the four risk categories. Items with little or no credit risk, such as cash and claims on central banks or governments, are in the first category with a zero percent risk weight. On the other hand, most claims against private parties appear in categories 3 and 4 with 50 and 100 percent risk weights, respectively.

Before off balance sheet items receive a risk weighting, they are first converted into balance sheet credit equivalents. The conversion factors used in this process depend on the extent to which an off balance sheet item substitutes for or is likely to result in a bank asset. Items that serve as direct credit substitutes, for example, are converted on a one-to-one basis, while the dollar amount of items posing less risk to a bank may be multiplied by conversion factors of 0, 20, or 50 percent.22

Capital standards and enforcement steps under prompt corrective action — Under the prompt corrective action standards, bank regulators assign individual banks to one of five capital categories. As shown in Table 5, a bank's capital holdings under the three basic capital measures will determine its capital category. A well-capitalized or adequately capitalized bank must meet or exceed the min-

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22 The conversion factors and related items are: 100 percent (direct credit substitutes, such as financial standby letters of credit; sale and repurchase agreements; asset sales with recourse; forward agreements to purchase assets; and securities lent that place a bank at risk), 50 percent (transaction-related contingencies, such as performance bonds and performance-based standby letters of credit; unused portions of commitments with an original maturity over one year; and revolving underwriting facilities), 20 percent (short-term, self-liquidating, trade-related contingencies, such as commercial letters of credit), and 0 percent (unused portions of commitments that either have an original maturity of under one year or are unconditionally cancelable).

In addition, conversion factors of 0, 0.5, and 1.5 percent apply to interest rate contracts, while factors of 1, 5, and 7.5 percent apply to exchange rate contracts. The higher percentages apply to contracts with a remaining maturity over one year. The notional amount of a contract is multiplied by the appropriate conversion factor to yield a measure of potential credit exposure, and this measure is added to the replacement cost or current credit exposure of the contract.
Table 5
Prompt Corrective Action Capital Guidelines

<table>
<thead>
<tr>
<th>Capital categories</th>
<th>Total risk-based capital ratio</th>
<th>Tier 1 risk-based capital ratio</th>
<th>Leverage ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Well capitalized*</td>
<td>10 percent or greater AND</td>
<td>6 percent or greater AND</td>
<td>5 percent or greater</td>
</tr>
<tr>
<td>Adequately capitalized</td>
<td>8 percent or greater AND</td>
<td>4 percent or greater AND</td>
<td>4 percent or greater**</td>
</tr>
<tr>
<td>Undercapitalized</td>
<td>Less than 8 percent OR</td>
<td>Less than 4 percent OR</td>
<td>Less than 4 percent**</td>
</tr>
<tr>
<td>Significantly undercapitalized</td>
<td>Less than 6 percent OR</td>
<td>Less than 3 percent OR</td>
<td>Less than 3 percent</td>
</tr>
<tr>
<td>Critically undercapitalized***</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

* In addition to meeting these capital standards, a well-capitalized bank must not be subject to any written agreement, order, capital directive, or prompt corrective action directive that requires the bank to meet and maintain a specific capital level for any capital measure.

** An adequately capitalized bank may have a leverage ratio of 3 percent or greater if its most recent examination rating was a “1” and it is not experiencing or anticipating significant growth. For an undercapitalized bank, the leverage ratio criteria is “less than 3 percent” if the bank’s most recent examination rating was a “1” and the bank is not experiencing or anticipating significant growth.

*** A bank is critically undercapitalized if its ratio of tangible equity to total assets is equal to or less than 2 percent.
imum percentages listed in the table for all three capital ratios. To be deemed undercapitalized or significantly undercapitalized, a bank need only fall below one of the percentages listed for its capital category. Critically undercapitalized banks are those with tangible equity equal to or less than 2 percent of their total assets.

These capital categories provide the basis for taking supervisory action and issuing directives under the prompt corrective action framework. This framework establishes a set of mandatory actions that regulators must take whenever a bank fails to maintain adequate capital. As shown in Table 6, these mandatory supervisory actions become more severe as a bank's capital declines. Well and adequately capitalized banks will not be subject to the mandatory actions as long as they do not take any steps that would leave them undercapitalized. For undercapitalized and significantly undercapitalized institutions, much of the focus is on submitting and implementing an acceptable plan to restore capital. Critically undercapitalized banks face receivership unless their condition improves quickly, and activities that might increase their risk exposure are to be restricted.

In addition to the mandatory actions, the prompt corrective action framework also includes a list of discretionary steps. For undercapitalized banks, the supervisory agencies may choose to take such steps if appropriate. With significantly undercapitalized banks, though, the agencies must impose at least one of the discretionary actions as a supplement to the mandatory provisions. Table 7 provides a listing of the suggested discretionary actions.

The prompt corrective action statutes provide federal banking agencies with the authority to take the specified steps against institutions within a given capital category. Supervisory agencies also

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23 A federal banking agency may elect to reclassify a well-capitalized bank as adequately capitalized or to require an adequately capitalized or undercapitalized bank to comply with more severe supervisory actions. Such changes may be made when a bank is in an unsafe or unsound condition or has failed to correct a less-than-satisfactory examination rating for asset quality, management, earnings, liquidity, or sensitivity to market risk.
Well Capitalized and Adequately Capitalized

May not make any capital distribution or pay a management fee to a controlling person that would leave the institution undercapitalized.

Undercapitalized

Subject to provisions applicable to well capitalized and adequately capitalized institutions.

Subject to increased monitoring.

Must submit an acceptable capital restoration plan within 45 days and implement that plan.

Growth of total assets must be restricted.

Prior approval from the appropriate agency is required prior to acquisitions, branching, and new lines of business.

Significantly Undercapitalized

Subject to all provisions applicable to undercapitalized institutions.

Bonuses and raises to senior executive officers must be restricted.

Subject to at least one of the discretionary actions presented in Table 7.

Critically Undercapitalized

Must be placed in receivership or conservatorship within 90 days unless the appropriate agency and the FDIC concur that other action would better achieve the purposes of prompt corrective action.

Must be placed in receivership if it continues to be critically undercapitalized, unless specific statutory requirements are met.

After 60 days, must be prohibited from paying principal or interest on subordinated debt without prior approval of the FDIC.

Activities must be restricted. At a minimum, may not do the following without the prior written approval of the FDIC:

- Enter into any material transactions other than in the usual course of business;
- Extend credit for any highly leveraged transaction;
- Make any material change in accounting methods;
- Engage in any “covered transactions” as defined in section 23A of the Federal Reserve Act, which governs affiliate transactions;
- Pay excessive compensation or bonuses;
- Pay interest on new or renewed liabilities at a rate that would cause the weighted average cost of funds to significantly exceed the prevailing rate in the institution’s market area.

Critically Undercapitalized, continued

Must be placed in receivership if it continues to be critically undercapitalized, unless specific statutory requirements are met.

After 60 days, must be prohibited from paying principal or interest on subordinated debt without prior approval of the FDIC.

Activities must be restricted. At a minimum, may not do the following without the prior written approval of the FDIC:

- Enter into any material transactions other than in the usual course of business;
- Extend credit for any highly leveraged transaction;
- Make any material change in accounting methods;
- Engage in any “covered transactions” as defined in section 23A of the Federal Reserve Act, which governs affiliate transactions;
- Pay excessive compensation or bonuses;
- Pay interest on new or renewed liabilities at a rate that would cause the weighted average cost of funds to significantly exceed the prevailing rate in the institution’s market area.
Table 7
Discretionary Supervisory Actions Applicable to Institutions in the Various Capital Categories

<table>
<thead>
<tr>
<th>Well Capitalized and Adequately Capitalized</th>
<th>Significantly Undercapitalized, continued</th>
</tr>
</thead>
<tbody>
<tr>
<td>None.</td>
<td>Require the institution to elect a new board of directors, dismiss any director or senior executive officer, or employ qualified senior executive officers;</td>
</tr>
<tr>
<td>Undercapitalized</td>
<td>Prohibit acceptance of deposits from correspondent depository institutions;</td>
</tr>
<tr>
<td>Subject to any discretionary actions applicable to significantly undercapitalized institutions if the appropriate agency determines that those actions are necessary to carry out the purposes of prompt corrective action.</td>
<td>Prohibit any controlling BHC from making any capital distribution without prior approval from the Federal Reserve Board;</td>
</tr>
<tr>
<td>Significantly Undercapitalized (Or undercapitalized banks that fail to submit or implement an acceptable capital plan)</td>
<td>Divest or liquidate any subsidiary in danger of becoming insolvent and posing a significant risk to the institution;</td>
</tr>
<tr>
<td>Actions the institution is presumed subject to unless the appropriate agency determines that such action would not further the purpose of prompt corrective action:</td>
<td>Require any controlling company to divest or liquidate any non-depository institution affiliate in danger of becoming insolvent and posing a significant risk to the institution;</td>
</tr>
<tr>
<td>Must raise additional capital or arrange to be merged with another institution;</td>
<td>Any other action that the appropriate agency determines would better carry out the purposes of Prompt Corrective Action.</td>
</tr>
<tr>
<td>Transactions with affiliates must be restricted;</td>
<td>Critically Undercapitalized Additional restrictions (other than those mandated) may be placed on activities.</td>
</tr>
<tr>
<td>Interest rates paid on deposits must be restricted to prevailing rates in the region.</td>
<td></td>
</tr>
<tr>
<td>Other possible discretionary actions:</td>
<td></td>
</tr>
<tr>
<td>Severely restrict asset growth or reduce total assets;</td>
<td></td>
</tr>
<tr>
<td>Terminate, reduce, or alter activities that pose excessive risk to the institution;</td>
<td></td>
</tr>
</tbody>
</table>
have authority under other statutes to take enforcement steps. In particular, provisions of the International Lending Supervision Act of 1983 give federal supervisory agencies general authority to issue capital directives to banks that fail to maintain appropriate capital levels. These directives may encompass the submission of an acceptable plan for restoring capital.

Proposed revisions to the risk-based capital framework – Since its adoption in the late 1980s, the risk-based capital framework has been highly successful in strengthening capital standards across many countries and in creating a common international standard for capital adequacy. More recently, though, these standards have shown a number of weaknesses. New, complex financial instruments, for instance, have made the standards more difficult to implement, and the existing risk weights have failed to address significant differences in the quality of individual loans and other assets. Also, the standards do not adequately adjust for steps an institution may take to mitigate its risk exposure, such as through the use of guarantees, collateral, netting agreements, or credit derivatives. These shortcomings have thus provided institutions with opportunities to arbitrage the standards and to assume higher risk profiles without adding more capital.

In response to these concerns, the Basel Committee on Banking Supervision issued a consultative paper in June of 1999 proposing a new capital adequacy framework. This framework would consist of three pillars: revised capital standards, a supervisory review process, and effective use of market discipline. The Committee suggested several alternatives for revising the capital standards. A principal element of the new standards is likely to be an internal ratings-based approach to credit risk, under which institutions with strong internal credit ratings systems would be allowed to use these systems to calculate the appropriate risk weights for their loans and corresponding capital needs. The Committee is also looking at whether external credit assessments, such as those developed by private rating agencies, or other standard
indicators of credit risk could be used to help assign risk weights. In addition, the consultative paper discusses methods for allowing greater recognition of credit risk mitigation instruments and techniques. The Committee has circulated these proposals for public comment and has plans to implement a new capital adequacy framework in 2001.

In addition to these proposals, the federal banking agencies have also discussed simplifying the capital standards for banks that do not have international operations and do not engage in complex activities, as might be determined by a bank’s asset size, nature of its activities, and risk profile. This approach would allow regulators to establish more complicated capital standards for larger banks with refined risk-management systems, while easing compliance for smaller institutions. Ideas for a simplified approach include a risk-based capital standard with risk weights tailored more closely to the structure and activities of non-complex institutions, a leverage ratio, or a modified leverage ratio that accounts for off-balance sheet exposures.

Other aspects of capital adequacy — In section 305 of the Federal Deposit Insurance Corporation Improvement Act of 1991, Congress asked the federal banking agencies to revise their risk-based capital standards to take account of interest rate risk, concentration of credit risk, and the risks of nontraditional activities. The banking agencies amended their risk-based capital guidelines to stress that these risks, as well as the overall ability of bank management to control financial and operating risks, should be considered in any capital adequacy assessments.

In addition, the federal banking agencies expanded their risk-based capital standards in 1997 to specifically address market risk in bank trading activities, as well as in foreign exchange and commodity positions taken in other parts of a bank. The market risk capital guidelines are based on a framework developed jointly by supervisory authorities from the countries represented on the Basel Committee on Banking Supervision. These guidelines apply to
institutions with a significant exposure to market risk through their trading activities. Under the guidelines, institutions must adjust their risk-based capital ratios to take account of losses that could arise from broad market movements in interest rates, equity prices, foreign-exchange rates, or commodity prices. In addition, institutions must account for changes in market values due to more specific risks, such as the credit risk of the issuer of a particular financial instrument. Banks subject to the market risk standards must use their own internal models to measure market exposures, and these models and an institution’s risk management practices must meet certain requirements under the implementing regulations.

The capital adequacy of bank holding companies is primarily evaluated by the Federal Reserve System. However, the FDIC and Comptroller of the Currency consider the condition of a holding company and its subsidiaries when they assess capital adequacy at individual banks under their jurisdiction. With several exceptions, bank holding company risk-based capital ratios are computed in much the same manner as for banks. Under Federal Reserve guidelines, bank holding companies with over $150 million in consolidated assets are expected to maintain a total capital-to-risk-weighted assets ratio of at least 8.0 percent and a Tier 1 capital-to-risk-weighted assets ratio of 4.0 percent or more. Several special capital rules apply to financial holding companies and their subsidiaries. The Federal Reserve, for instance, may not impose capital adequacy standards on nondepository subsidiaries that are in compliance with the capital requirements of their federal regulator or state insurance authority.

Capital adequacy policies and decisions of state authorities differ in some ways from federal policies. However, many of the same factors are taken into account. National and state banks also face a number of other regulations relating to their capital holdings. Banks are prohibited from withdrawing or impairing their capital through excessive dividend payouts or other means. Member banks must have regulatory approval to pay dividends that exceed
net profits for that year and retained earnings for the preceding two years. For any insured bank, dividend payments that would endanger the bank can be restricted under the general enforcement and cease and desist powers of the federal regulators. In addition, many other regulations are phrased in terms of a percentage of a bank’s capital — as, for example, total loans to a single borrower.

**Restrictions on investment banking**

In the 1930s, a number of restrictions were placed on the ability of banks and their affiliates to engage in investment banking and to hold stocks for their own account. Most of these restrictions were imposed in the Banking Act of 1933, which is commonly referred to as the Glass-Steagall Act.

The restrictions on investment banking activities stemmed from the 1929 stock market crash and the perceived role of some banks in the market’s collapse. This separation of banking and securities activities also arose from the fear that a company engaged in both activities would experience serious conflicts of interest — conflicts that might be resolved to the detriment of bank depositors or investors. As an example, a bank might be tempted to favor its existing corporate customers by recommending their stocks to investors or by lending investors the funds to buy such stocks. In addition, a bank might face a conflict of interest in helping a loan customer issue new securities, because the funds obtained from issuing securities could go towards paying off the customer’s loans. In many cases, though, these types of conflicts might be offset by a bank’s desire to maintain a favorable image and reputation with its customers and in the capital markets.

In recent years, there has been a strong debate over the Glass-Steagall restrictions. This debate has centered on whether these restrictions are needed to limit potential conflicts or should be removed in the interest of bringing additional competition into securities markets and allowing banks to more fully meet customer
needs. The Gramm-Leach-Bliley Act of 1999 attempts to address these issues by allowing a broader range of securities activities in the subsidiaries of holding companies and banks, where the conflicts and risks of such activities can be more readily separated from affiliated banks and their operations. At the same time, this legislation leaves much of the framework in place that limits the investment banking activities a bank can do directly.

The Gramm-Leach-Bliley Act repeals sections 20 and 32 of the Banking Act of 1933. Section 20 had prevented member banks from affiliating with organizations “engaged principally in the issue, flotation, underwriting, public sale, or distribution of stocks, bonds, debentures, notes, or other securities.” Similarly, section 32 prohibited member banks and their officers, directors, and employees from having ties with an investment banking concern. The removal of these provisions thus gives banks an opportunity to affiliate with firms conducting a wide range of securities activities.24

Before exercising these securities powers, though, a banking organization must comply with the standards contained in the Gramm-Leach-Bliley Act, including the requirement that all of its depository institution subsidiaries be well capitalized, well managed, and have at least satisfactory CRA ratings.25 Organizations that elect to become financial holding companies are then authorized to underwrite, deal in, or make a market in all types of securities, including mutual funds, and must notify the Federal Reserve Board within 30 days after commencing such activities. Financial holding companies may also engage in merchant banking.26

24 A bank and any other financial institution or company are held to be affiliates if they are under common control, such as might occur if a majority of directors or at least 25 percent of the ownership of both institutions or companies were in common.

25 For more information on the activities and regulatory standards for financial holding companies, see pages 157–59 of this book.

26 These merchant banking activities typically involve making substantial investments in companies for the purpose of selling later at an anticipated profit. Merchant bankers may help in restructuring a company for resale and setting general strategies, but do not play an active managerial role in the company. Merchant banking activities of financial holding companies must conform to regulations issued by the Federal Reserve Board and the Secretary of the Treasury (12 CFR 225, subpart J; 12 CFR 1500).
ditional bank holding companies are still restricted to securities activities that the Federal Reserve Board had approved by regulation or order prior to the 1999 legislation.

Similarly, the financial subsidiaries of national banks may engage in a number of investment banking activities beyond what banks can do. In addition to the activities authorized for banks, the financial subsidiary of a national bank may engage in all types of securities underwriting and dealing as long as the bank and its depository institution affiliates are well capitalized and well managed.\textsuperscript{27} At the time the activities are begun, the national bank and each depository institution affiliate must have at least satisfactory CRA ratings. Well-capitalized state banks may establish financial subsidiaries, too, and conduct the same activities as a principal that are permissible for national bank financial subsidiaries.

In contrast to this broader authority for affiliates, the securities activities of banks are still restricted by sections 21(a)(1) and 16 of the Banking Act of 1933.\textsuperscript{28} Section 21(a)(1) of this act makes it unlawful for any person or firm to engage in investment banking activities and at the same time receive demand or time and savings deposits. By investment banking activities, the act means issuing, underwriting, selling, or distributing stocks, bonds, debentures, notes, or other securities. Section 16 specifies the range of securities activities that are open to national banks. For example, national banks can buy and sell investment securities upon the order and for the account of a customer, and they can hold investment securities of their own, subject to statutory limits on individual issues and regulations of the Comptroller of the Currency. No restrictions are placed on a national bank’s authority to deal in,

\textsuperscript{27} 12 U.S.C. §24a. If a national bank is one of the 50 largest insured banks, it must meet an additional requirement of having at least one issue of outstanding debt that is rated in one of the three highest rating categories. A bank among the next 50 largest must also meet the same ratings standard or have a long-term issuer credit rating in the three highest categories.

underwrite, or purchase for its own account obligations of the federal government, general obligations of states and political subdivisions, and certain federal agency securities. State member banks are also subject to these same provisions.

While these sections of the 1933 act establish the general investment banking restrictions for most commercial banks, several points have been further clarified in the Banking Act of 1935. For example, the 1935 act gives state banks, trust companies, other financial institutions, and private bankers the same investment securities powers granted national banks. Additionally, the 1933 act raised questions about the ability of financial institutions to conduct stock transactions. Therefore, the 1935 legislation gives member banks the ability to purchase and sell stocks without recourse but only upon the order and for the account of customers. Member banks are specifically prohibited from holding shares of corporate stock for their own account.

The Gramm-Leach-Bliley Act further extends the securities powers of banks by giving national banks unrestricted authority to deal in, underwrite, and purchase for their own account municipal revenue bonds, provided the bank is well capitalized. The same provisions apply to state member banks if the activities are authorized as well by state law or wildcard statutes.29

This legal framework establishes the general investment banking powers of banks and their affiliates. A number of regulatory agency rulings and federal court decisions over the past few decades have also helped interpret and establish the boundaries of securities powers for banks and bank holding companies in such

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29 The Gramm-Leach-Bliley Act, however, removes the blanket exemption that banks have had from registering as broker-dealers under the Securities and Exchange Act of 1934. Instead, the act provides a number of exemptions from registration for certain traditional banking activities that involve securities transactions (See 12 U.S.C. §78c(a)(4-5)). Banks that cannot meet these exemptions would generally have to move the noncomplying activities out of the bank and into a separate subsidiary or affiliate.
areas as securities brokerage, financial advisement, mutual fund services, and securities underwriting. However, as banking organizations form financial holding companies and bank financial subsidiaries, the Gramm-Leach-Bliley Act will supercede many of these regulatory rulings and court decisions. In addition, banks must comply with a number of other securities laws and regulations. Depending upon the activities, a banking organization will have to comply with such laws as the Securities and Exchange Act of 1934 and the Investment Company Act of 1940 and with direct SEC supervision of securities subsidiaries.

One final area of regulatory interest with regard to bank securities activities is in disclosures to customers. In their securities operations, banking organizations must follow any applicable SEC disclosure requirements. Moreover, the federal banking agencies issued joint guidelines in 1994 to ensure that retail customers are clearly informed about the risks of nondeposit investment products. Under these guidelines, a bank must make oral and written disclosures to customers specifying that mutual funds are: (1) not insured by the FDIC, (2) not a deposit or other obligation of, or guaranteed by, the bank, and (3) subject to investment risks, including possible loss of the principal amount invested. These guidelines further contain a number of provisions relating to training and supervision of sales personnel, customer suitability recommendations, third-party arrangements, and physical separation of mutual fund and deposit operations to prevent customer confusion.

**Bank relationships with affiliates**

In addition to the limitations on securities affiliates and investment banking ties, several other restrictions apply to a bank’s relationship with other affiliates and to the activities of affiliates. These

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restrictions were developed primarily in the interest of holding banking risks to a level consistent with protecting depositors and the deposit insurance system. Some of the restrictions were introduced to prevent insider abuses, avoid conflicts of interests, and limit tie-in sales to bank customers.

Activities of bank affiliates are limited by the Bank Service Corporation Act of 1962, as amended, and by the Bank Holding Company Act and its 1970 amendments. The Bank Service Corporation Act allows insured banks to organize and hold the stock of bank service corporations. These corporations may perform such routine banking services as check handling and accounting functions for depository institutions. They may also engage in any service, other than deposit taking, authorized for the parent bank or banks, provided similar geographic restrictions are followed. In addition, under the Garn-St Germain Act, bank service corporations can engage in any nondeposit-taking, nonbanking activity the Federal Reserve Board determined, by regulation, to be permissible for a bank holding company prior to November 1999. Before a bank service corporation can engage in such nonbanking activities, though, an application or notice must be sent to the Federal Reserve Board for its approval. Other bank service corporation activities require that prior notice be given to a bank’s primary federal supervisor.

Under the Bank Holding Company Act and its amendments, the parent holding company of a bank can conduct a range of activities through the holding company itself or through a nonbank subsidiary. Under the Gramm-Leach-Bliley Act of 1999, traditional bank holding companies can engage in nonbanking activities that the Federal Reserve Board determined to be closely related to banking prior to November 1999. Financial holding companies can engage in the same activities as well as a broader array of financially related activities, including securities underwriting and dealing, insurance agency and underwriting activities,
and merchant banking. In addition, financial holding companies can engage in any activity that the Board and the Secretary of the Treasury jointly determine to be financial in nature or incidental to financial activities or that the Board determines to be complementary to financial activities without posing a substantial risk to depository institutions or the financial system. The financial subsidiary of a bank can also engage in activities that are financial in nature or incidental to such activities, provided these activities do not involve insurance underwriting, real estate development or investment, or merchant banking.

In the interest of protecting depositors from the risk of these broader activities and preventing insider abuses and misapplication of bank funds, federal banking laws restrict transactions between insured banks and their affiliates. For example, credit extensions, advances, purchases of assets, or investments in a single affiliate of an insured bank are limited to 10 percent of the bank’s capital stock and surplus. Other transactions included in this limit are guarantees issued on behalf of an affiliate and the acceptance of an affiliate’s securities as collateral for any loan. The total of such credit extensions, investments, and other transactions involving all affiliates is limited to 20 percent of bank capital stock and surplus. These affiliate restrictions do not apply to transactions between subsidiary banks of a holding company, provided the company owns 80 percent or more of the voting stock of each bank.

Under the Gramm-Leach-Bliley Act of 1999, the restrictions on transactions with affiliates extend to the financial subsidiaries of banks. However, the 10 percent limit on transactions with an individual affiliate does not apply to transactions between a bank and a financial subsidiary. As a result, a bank may lend or invest up to 20 percent of its capital and surplus in a single financial subsidiary.

Any transactions with affiliates must further be on terms and conditions that are no more favorable to the affiliate than those that would be available in comparable transactions with nonaffiliated third parties. These restrictions are contained in sections 23A and 23B of the Federal Reserve Act for member banks (12 U.S.C. §§371c and 371c-1) and section 18(j)(1) of the Federal Deposit Insurance Act for nonmember insured banks (12 U.S.C. §1828(j)(1)).
under circumstances that are the same, or at least as favorable to
the bank, as comparable transactions with other parties. Credit
extensions must be secured according to statute. In addition, an
insured bank generally cannot purchase low-quality assets from
any of its affiliates. Examples of low-quality assets are classified
loans and securities, assets in nonaccrual status, and past due assets.
Moreover, an insured bank may not suggest in any way that it is
responsible for the obligations of its affiliates.

Other restrictions apply to a bank’s dealings with its affiliates.
For example, certain tie-in arrangements between a bank, its hold-
ing company parent, and any subsidiaries of the holding company
are prohibited by the Bank Holding Company Act Amendments
of 1970. This prohibition prevents banking organizations from
offering a service on the condition or requirement that a customer
purchase additional services from the organization or its sub-
sidiaries. To protect bank funds, the Federal Reserve also examines
management contracts, services, personnel use, and other relation-
ships between a bank and its holding company.

Reserve requirements

Reserve requirements were originally adopted in state and
national banking systems as a liquidity measure to counter deposit
drains or note conversions and to protect bank customers. This
objective, however, no longer receives much attention. Emergency
liquidity and public confidence are presently provided through the
Federal Reserve’s monetary policy and lender of last resort roles
and through the deposit insurance system. Required reserves,
moreover, provide little support by themselves for depositors.
Deposits are only partially backed by reserves under our fractional
reserve system, and many types of deposits no longer carry reserve
requirements. Also, due to their required nature, a bank’s reserve
holdings usually are not available to meet liquidity needs. As a con-
sequence, reserve requirements are now seen mainly as a tool of monetary policy.

The Depository Institutions Deregulation and Monetary Control Act of 1980 requires all depository institutions offering transaction accounts to maintain reserves with the Federal Reserve System either directly or through other institutions. Previously, only member banks were required to hold reserves at Federal Reserve banks. The 1980 act set reserve requirements at 3 percent on the first $25 million in transaction accounts (raised to $42.8 million for 2001) and 12 percent on greater amounts. In April 1992, the Federal Reserve lowered the 12 percent reserve requirement to 10 percent in order to help strengthen the balance sheets of banks and put them in a better position to extend credit. Nonpersonal time deposits and Eurocurrency liabilities required 3 percent reserves after implementation of the 1980 legislation. However, the Federal Reserve eliminated this requirement in December 1990, leaving transaction accounts as the only type of deposit subject to required reserves. Reserves can be held in the form of vault cash, reserve balances at a Federal Reserve Bank, or pass-through accounts at a correspondent, Federal Home Loan Bank, or Central Liquidity Facility for credit unions.

Because required reserves earn no interest, they affect the earnings of banks, lowering profitability and reducing the ability of banks to compete with nondepository institutions. As a result, many banks offer repurchase agreements and sweep accounts which move funds on an overnight or weekend basis from reservable transaction accounts into investments or other deposit accounts not subject to reserve requirements. In addition, a number of banks have developed sweep accounts which are linked to a customer’s checking account and automatically transfer funds to a money market fund or other high-yield investment when the balance falls below a certain level. This allows banks to earn interest on the funds in excess of the required reserve requirements while still maintaining the appearance of a flexible checking account.

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33 Under Federal Reserve Regulation D (12 CFR 204), transaction accounts include demand deposit accounts, negotiable order of withdrawal (NOW) accounts, share draft accounts, and other accounts which allow transfers or payments to third parties.

34 Under the Garn-St Germain Depository Institutions Act of 1982, the first $2 million in reservable liabilities held by a depository institution is not subject to reserve requirements. This threshold was raised to $5.5 million in 2001.
ber of bills have been introduced in Congress over the past few years to pay banks interest on their reserves, add such interest payments to the bank insurance fund, or allow banks more flexibility in sweeping funds out of transaction accounts.

**Extensions of credit by Federal Reserve banks**

When the Federal Reserve Act was passed in 1913, credit extensions by Federal Reserve banks to member banks were designed to serve two purposes. One was to provide an elastic currency and reserve base by establishing an outside source of reserves and liquidity for the banking system. In fact, a major intent of those designing the Federal Reserve System was to create a lending function that would help fund the credit needs of the economy, as well as limit or curtail banking panics and monetary disruptions. The other purpose of credit extensions was to aid banks with temporary liquidity problems. By extending short-term credit to banks with unexpected deposit drains or other problems, the Federal Reserve could help banks avoid more drastic steps, such as a hurried liquidation of loans. As a consequence, banks would have a better chance of averting situations that could worsen their condition or lessen confidence in the banking industry. These objectives still govern the Federal Reserve's lending to depository institutions.

Since the Monetary Control Act of 1980, any depository institution offering transaction accounts or nonpersonal time deposits is eligible to obtain credit from the Federal Reserve System. This credit is granted according to the rules of Federal Reserve Regulation A.35 Federal Reserve lending can be in the form of short-term adjustment credit for temporary needs, seasonal credit for smaller institutions with a strong seasonal pattern in their deposits or loans, or other extended credit for those experiencing exceptional

circumstances and more sustained problems. In addition, the Federal Reserve may lend to individuals, partnerships, and corporations in “unusual and exigent circumstances,” but this lending authority has seldom been employed.

Federal Reserve credit is to be used only to meet a demonstrated need and for appropriate purposes. For instance, such borrowing is not to be used as a substitute for capital, to speculate in or increase investments, to provide funding for a loan expansion program, or to take advantage of discount rates whenever they are more favorable than rates on competing sources. Also, borrowing requests are not to be initiated until all other sources of funds have been exhausted, including any special industry lenders.

A Reserve Bank can extend credit either through advances secured by acceptable collateral or through the discount of eligible paper, although discount borrowing is seldom used. Collateral for advances includes U.S. Government and agency securities; acceptable quality state and local government securities; mortgage notes covering one- to four-family residences; and business, consumer, and other customer notes. Federal Reserve banks set the basic rate for advances and discounts subject to review and approval by the Board of Governors. Flexible rates are charged for seasonal credit and for other extended credit provided for more than 30 days. These rates take into account the rates on market sources of funds and are always equal to or greater than the basic discount rate.

In addition to these requirements, borrowing by troubled institutions must meet a number of other standards introduced in the Federal Deposit Insurance Corporation Improvement Act of 1991. The intent of these provisions is to curtail lending to failing institutions, particularly if the lending would serve to delay timely resolution of their problems and, as a result, cause greater losses for the FDIC. Undercapitalized institutions may not borrow for more than 60 days in any 120-day period unless their federal banking supervisor or the chairman of the Federal Reserve Board certifies them as viable. For critically undercapitalized institutions, this
lending period only extends for the first five days after they become critically undercapitalized. The Federal Reserve could choose to lend beyond these bounds, but the System would be liable for added losses the FDIC might experience in the event the institution failed.

Apart from borrowing from the Federal Reserve, an insured bank is eligible for membership in a Federal Home Loan Bank (FHLB) and, accordingly, access to its cash advance program. FHLB lending to the banking industry has expanded rapidly in recent years, and this trend promises to continue as a result of provisions in the Gramm-Leach-Bliley Act of 1999 which expand the number of banks eligible for membership in the FHLB system and broaden the purposes for which advances may be used. To become a member, a bank must have at least 10 percent of its assets in residential mortgage loans or have less than $500 million in total assets (a "community financial institution"). Banks also must meet certain standards regarding financial condition, character of management, and home financing policies. Membership and borrowing further require a bank to purchase Federal Home Loan Bank stock in proportion to its asset size and the amount of advances it receives.

Long-term advances from FHLBs must serve one of two purposes: providing funds for residential housing finance or providing funds to community financial institutions for lending to small businesses, small farms, and small agri-businesses. These advances must be fully secured by current first residential mortgages or related securities; certain other low-risk, real estate-related collateral; U.S. Government or agency securities; deposits at a Federal Home Loan Bank; or, in the case of community financial institutions, secured loans for small business and agricultural purposes or related securities. FHLBs also have community investment and affordable housing programs that are designed to provide lower-rate advances to member institutions for financing housing and

community development for low- and moderate-income households and neighborhoods.

Deposit interest rate limitations for insured institutions

Interest rate ceilings on time and savings deposits and the interest rate prohibition on demand deposits were legislated after the banking panics in the early 1930s. Although the rationale was not widely discussed then, interest controls were presumably adopted as a means of limiting interest rate competition among banks, thus raising bank profitability while reducing risks. Interest ceilings were extended to insured savings and loan associations in 1966 in an effort to keep their interest costs in line with the yields on their mortgage portfolios. Rate ceilings were set higher for savings and loans than for commercial banks to support a continued flow of funds to housing and thus avoid any liquidity crisis for institutions holding long-term mortgages.

Beginning with the 1970s, however, the effect of interest rate controls was more adverse than favorable. Ceilings hindered depository institutions in competing with less regulated institutions that could offer higher rates for funds. Interest controls also appeared to have no favorable effect on bank profitability. With ceilings, banks were forced to use many indirect and often inefficient methods of competing for deposits. Consequently, interest rate ceilings had come to be viewed as a hindrance to competition and of little help in controlling banking risks. In addition, by reducing returns on deposits, controls may have done more to harm depositors than to protect them.

The Monetary Control Act was passed in 1980 with a six-year phase-out of interest rate controls for time and savings deposits. The act established the Depository Institutions Deregulation Committee (DIDC) and directed that interest rate ceilings be phased out as rapidly as economic conditions would permit. The
interest ceilings on time and savings deposits were subsequently moved to less restrictive levels and then eliminated in a series of steps. On April 1, 1986, the final step was taken when the ceiling on savings deposits was removed.

As a result of these steps, only the terms on demand deposits remain regulated, with a statutory prohibition against any interest payments on such accounts. Depository institutions now have the freedom to select the interest rates they will pay on time and savings deposits, provided they remain well capitalized. For other institutions, the Federal Deposit Insurance Corporation Improvement Act of 1991 imposes a number of constraints on deposit interest rates. Undercapitalized institutions may not solicit deposits by offering a rate that is more than 75 basis points above the prevailing rate paid on comparable deposits. Significantly undercapitalized institutions, as well as any undercapitalized institution that fails to submit and implement a capital restoration plan, generally must restrict deposit rates to prevailing market rates, and a critically undercapitalized bank cannot pay rates on new or renewed liabilities that would bring its average cost of funds significantly above market rates. Other rate limitations apply to brokered deposits.

**Brokered deposits**

Brokered deposits refer to deposits placed in depository institutions by third-party sources rather than directly by the depositor. Ideally, such deposits provide for a more optimal flow of funds within the banking system, particularly if deposit brokers can help depositors find the highest rates available for their funds, while channeling funds to institutions with the best use for them.

Much of the significant expansion in brokered deposits during the 1980s, however, did not closely adhere to this market ideal. In particular, brokered deposits became a convenient funding vehicle for some problem thrifts and banks, as they sought to cover their
losses and quickly reverse their declines through speculative strategies and rapid growth. These institutions, by offering higher rates than others, were able to attract significant amounts of brokered deposits. Moreover, their adverse condition put little constraint on such funding, since brokers commonly divided large deposits among enough institutions to maintain full insurance coverage. This brokered funding thus subverted many of the normal market constraints on problem institutions and kept such institutions from having to curtail highly risky activities.

To monitor the use of brokered deposits and lessen potential deposit insurance losses, federal banking agencies instituted quarterly reporting requirements on brokered deposits in 1983. These were supplemented a year later with more frequent reporting by banks having significant levels of brokered deposits. Examinations and enforcement actions have also been used to detect and control abuses of brokered deposits.

The most comprehensive steps to regulate the use of brokered deposits, however, took place in 1989 and 1991. Congress gave the FDIC formal authority in 1989 to prohibit troubled institutions from accepting brokered deposits. These standards were further tightened in the Federal Deposit Insurance Corporation Improvement Act of 1991.

Under the implementing regulations, only institutions that are well capitalized according to the prompt corrective action capital standards may solicit, accept, or renew brokered deposits without any restrictions. Adequately capitalized institutions must apply for and receive a waiver from the FDIC before entering the brokered deposit market. Also, the rates they pay for such deposits cannot be significantly higher than (within 75 basis points of) the prevailing rates on similar deposits in their market area or a national rate for deposits accepted from outside this area.

Undercapitalized institutions may not use brokered deposits.

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37 12 CFR 337.6, as it implements 12 U.S.C. §§1831f, 1831f-1.
The only exception to this is for an institution that has been under FDIC conservatorship for less than 90 days, provided the deposits would not harm the institution and would help it meet its obligations. The brokered deposit regulations generally require deposit brokers to register with the FDIC and to maintain records on the deposits they place. As a result of these restrictions, sound institutions can continue to use brokered deposits as a means of channeling funds according to market needs. Problem institutions, however, will not be able to rely on brokered deposits and higher deposit rates to support or expand their operations.

**Off balance sheet items**

In addition to the exposure within a bank's portfolio, risk can also be affected by commitments that are not directly reflected on a bank's balance sheet. Some examples of the many contingent liabilities and commitments in banking are:

- Commercial letters of credit
- Standby letters of credit
- Lawsuits
- Repurchase agreements
- Loan commitments
- Futures, forward, and standby contracts for securities
- Commitments to buy and sell foreign exchange
- Interest rate swap agreements

Several regulatory means are used to estimate or control the risk from off balance sheet commitments. Some commitments, for example, are prohibited by law. Others are regulated through the supervisory and examination process and monitored through reporting requirements. Many off balance sheet items must also be backed by capital under the risk-based capital requirements.
Finally, bankers must be aware of the regulations that apply if a commitment results in a balance sheet item.

Bank examiners try to derive the amount of a bank’s contingent liabilities and assess the possible risks of these items. They also review any formal policies and guidelines that a bank has for granting letters of credit, making loan commitments, entering into foreign exchange contracts, or trading interest rate futures contracts. Bank supervisors expect bankers to apply the same credit analysis and lending policies to letters of credit as would be applied to bank loans.

Regulatory agencies have established their own policies, guidelines, and interpretations for bank involvement in foreign exchange and interest rate futures contracts. Supervisory policies usually view futures contracts as appropriate when the contracts are used to hedge or lower the risk of a bank’s position in these markets. On the other hand, regulators strongly discourage banks from futures activities that would increase risk and primarily involve speculation on future movements in interest or exchange rates. With the recent and rapid growth in various derivative instruments at larger banks, bank regulators also are starting to pay very close attention to the level of management oversight given to these activities and to the expertise of a bank’s staff in judging and limiting the bank’s risk exposure.

Reporting requirements have become more important over the last decade in monitoring and controlling the use of off balance sheet items in banking. Such requirements had previously been minimal. Prior to the 1980s, most bankers had few significant contingent liabilities, and those they had were usually short-term, low-risk commitments, such as commercial letters of credit. However, with the growth in repurchase agreements, loan commitments, standby letters of credit, foreign exchange trading, and interest rate swaps and futures contracting, the need has increased for reporting these commitments to stockholders and bank regulators. Since 1983, all banks must report on each major category...
of commitments and contingencies. This report is filed as a separate schedule in the quarterly Report of Condition.

Because banks may eventually have to meet their commitments, supervisory policies and balance sheet regulation can also affect bank commitments. Examples of this include limits on loans to a single borrower, credit evaluations, and restrictions on eligible bankers acceptances.

**Other regulations for depositor protection**

Among the other regulations designed to protect depositors and control banking risks is the Bank Protection Act of 1968, which is implemented for a bank by its primary federal supervisor. This act sets minimum standards for security and protection devices and for the security procedures of insured banks. As a means of encouraging liquidity and keeping banks out of the real estate business, section 24A of the Federal Reserve Act limits a member bank’s investment in its premises. This investment must either be approved by the member bank’s primary federal supervisor, be no more than the bank’s capital and surplus, or, for banks that have a CAMELS composite rating of ‘1’ or ‘2’ and are well capitalized, be no more than 150 percent of capital and surplus. Other regulations and supervisory policies govern such activities and items as bank insurance activities, director and management qualifications, and deposits of public funds in banks.

In addition, under the Federal Deposit Insurance Corporation Improvement Act of 1991, as amended, the three federal banking agencies were required to issue safety and soundness guidelines containing standards for such banking factors as internal controls and audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, and compensation. These interagency guidelines appear at 12 CFR 30 for national banks, 12 CFR 263 for state member banks, and 12 CFR 308, subpart R, for state nonmember banks.
sions of this act also attempt to limit the exposure that a bank might have to other depository institutions through correspondent transactions and credit relationships.\textsuperscript{40}

\section*{Supervisory Compliance Procedures}

The principal supervisory procedures used to check compliance with banking regulations and protect depositors fall under the categories of bank examinations, bank holding company inspections, reporting requirements, surveillance systems, enforcement actions, and FDIC assessments and policies. In addition to these supervisory procedures, many banks and holding companies must also submit an annual report to federal and state banking agencies containing annual financial statements, statements by bank management, and an independent public accountant’s report. Many aspects of these supervisory methods have already been discussed in terms of the particular banking activities they affect. Consequently, this section looks at the operational aspects of supervision and the framework used to develop an overall view of a bank and its ability to protect depositors.

\subsection*{Bank examinations}

Bank examinations are used to collect on-the-spot information that will indicate the current financial condition of a bank and its compliance with applicable laws and regulations. As shown in Figure 1, all phases of a bank’s operations are covered in an examination, and special reviews are made of trust activities, electronic data processing operations, and compliance with consumer protection laws. An examination thus provides a comprehensive picture of a bank’s operations and financial performance. Bank exams, though, do not serve as audits. Examiners confine themselves to evaluating

\begin{footnotesize}
\textsuperscript{40} These provisions are implemented through Federal Reserve Regulation F (12 CFR 206).
\end{footnotesize}
only the activities and bank records that are necessary to judge a bank's condition and regulatory compliance. Generally, the scope of an examination is limited to the bank's records and does not include verifying all of the bank's asset and liability account balances.

To help reduce supervisory burden further, make better use of examiner resources, and take a more forward-looking approach, the banking agencies began developing a new supervisory framework in the mid-1990s. The key element in the new framework is bank examinations that focus more closely on the areas of greatest risk to a particular bank. This risk-focused examination process requires examiners to first perform a risk assessment of a bank before beginning any on-site supervisory activities. Risk assessments involve identifying the significant activities of a bank, determining the risks inherent in these activities, and undertaking a preliminary assessment of the processes a bank has in place to identify, measure, monitor, and control these risks. Examiners then use a bank's risk assessment to direct their examination efforts toward the areas of greatest risk to the institution. For banks with sound risk-management processes, examiners can rely more heavily on a bank's own internal risk assessments rather than having to perform extensive supervisory tests.

Federal bank supervisors review six critical aspects of a bank's operations and condition in their examination rating procedure, commonly called the CAMELS rating system. The aspects are:

- Capital adequacy
- Asset quality
- Management and administrative ability
- Earnings level and quality
- Liquidity level
- Sensitivity to market risk

Banks are rated from ‘1’ to ‘5’ on each of these aspects. A ‘1’ is the highest rating and indicates the strongest performance, best
COMMERCIAL BANK REPORT
OF EXAMINATION

Name: ____________________________  Examination Date: _______________________

Location: __________________________  Examination Start Date: ___________________

RSSD ID Number: ____________________

THIS REPORT OF EXAMINATION IS STRICTLY CONFIDENTIAL

This report has been prepared by an examiner selected or approved by the Board of Governors of the Federal Reserve System. The report is the property of the Board of Governors and is prepared to assist in the supervision of the banking industry. It is generally developed and confidential under applicable law, and the Board of Governors has foreclosed its disclosure to any person other than its participant, except in limited circumstances specified in the law (12 U.S.C. 4512(c) and (d)(3)) and in the regulations of the Board of Governors. The information or opinion contained in this report may subject the person or persons furnishing or reviewing such information to the penalties of Section 6 of the U.S. Criminal Code (18 U.S.C. 64). Each director or officer, in keeping with his or her responsibilities, should fully evaluate the contents of this report. In making this review, it should be noted that this report is not an audit, and should not be considered as such. Management is required by law to send a copy of this report to independent auditors engaged to conduct audits of the institution. Under no circumstances should the directors, officers, employees, auditors or independent auditors disclose or make public this report or any portion thereof except in accordance with applicable law and the regulations of the Board of Governors.

The information contained in this report is based upon the books and records of the bank, upon statements made to the examiner by directors, officers, and employees, and upon information obtained from other sources believed to be reliable and prepared to the examining examiner to be correct.

FEDERAL RESERVE BANK OF KANSAS CITY

Note: This figure is referenced on page 116.
Figure 1, continued

Table of Contents

MESSAGE TO THE BOARD OF DIRECTORS/TRUSTEES: This Report of Examination consists of three major sections, Conclusions and Recommendations, Assessment, and Supplemental Information. The Conclusions and Recommendations section contains the examination conclusions and comments. The Assessment section contains an analysis of management, asset quality, capital, earnings, sensitivity to market risk, liquidity, and risk management. The Supplemental Information section contains financial schedules which support corresponding pages.

Conclusions and Recommendations

Scope
Examination Conclusions and Comments

Assessment

Management/Administration
Asset Quality
Capital Adequacy
Liquidity
Earnings
Sensitivity to Market Risk

Supplemental Information

Capital Calculations
Analysis of Earnings
Loans and Lease Financing Receivables
Intrasubject to Adverse Classification
Signatures of Directors

Page 1 of 2
risk-management practices, and least degree of supervisory concern. On the other hand, a ‘5’ is the lowest rating and implies the weakest performance, inadequate risk-management practices, and highest level of supervisory concern. In making these ratings, examiners follow many of the procedures discussed earlier in this chapter. A bank’s performance in these categories is then compared with the performance of other banks operating under similar circumstances.

Capital ratings, for example, partly reflect how a bank’s capital compares to the capital of other banks and to established capital standards. In rating capital at a particular bank, though, examiners assess whether the bank is maintaining capital commensurate with the nature and extent of risks it assumes and whether bank management has the ability to identify, measure, monitor, and control these risks. Among the individual factors examiners use to assess capital adequacy are the level and quality of capital; ability of management to address the need for additional capital; the nature, trend, and volume of problem assets; adequacy of loan loss allowances; balance-sheet composition and inherent risks; and risk of off balance sheet activities. Other factors considered by examiners are the quality and strength of bank earnings, reasonableness of dividends, prospects and plans for growth, and access to capital markets and other sources of capital.

Asset quality ratings are determined by the amount of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, and other assets and off balance sheet transactions. In particular, examiners assess such factors as the adequacy of a bank’s loan underwriting standards and loan and investment policies; the volume and severity of problem, classified, and nonperforming assets; adequacy of loan loss allowances; and existence of asset concentrations and degree of diversification in the loan and investment portfolios.

Management ratings are assessed according to the capability of a bank’s board of directors and management to identify and control the bank’s risk exposure and to ensure safe, sound, and effi-
cient banking operations in compliance with applicable laws and regulations. This capability is rated according to the level and quality of oversight the board of directors and management provides; ability to plan for and respond to emerging risks; and adequacy of internal policies, controls, audits, and information and risk-monitoring systems. Examiners also look at many other management aspects, including regulatory compliance, management succession plans, avoidance of self-dealing, willingness to serve the community, and the overall performance of the bank.

A bank’s earnings rating is based on the level and trend of its earnings, adequacy of earnings for supplying internal capital and meeting possible loan losses, quality and sources of earnings, level of expenses, adequacy of budgeting and forecasting processes, and the exposure of earnings to various risks. In rating bank earnings, examiners typically compare a bank’s returns to those of similar banks (“peer banks”) in order to assess whether a bank is achieving above or below average profitability.

Liquidity is rated according to whether an institution can maintain a level of liquidity sufficient to meet its financial obligations in a timely manner, while fulfilling the banking needs of its community. Banks are expected to meet liquidity needs through such means as maintaining their deposit base, holding assets that are readily convertible into cash, having access to money markets and other funding sources, diversifying funding sources, securitizing assets, and following effective funds-management practices.

Ratings for a bank’s sensitivity to market risk are based on the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices would adversely affect the bank’s earnings or the value of its capital. Examiners further assess the ability of management to measure and control these exposures, as well as the nature and complexity of such risks.

Once ratings are assigned to each of these six categories, examiners combine the ratings to form a composite rating for the bank. In the process, examiners weight each category by its relative
importance to the bank’s overall condition and the interrelationship with the other ratings components. Other factors influencing a bank’s condition may also be considered. This composite rating thus reflects a bank’s overall condition and indicates which banks are sound and capable of withstanding economic fluctuations, and which banks are weak and require corrective action and close supervisory attention. The banking agencies disclose the composite and component ratings to a bank’s board of directors and senior management and also provide a written report of the examination.

The frequency with which banks are examined varies somewhat according to their size and condition. Under federal law, banks must have a full-scope, on-site examination at least once every 12 months. This schedule, though, can be extended to 18 months for banks with total assets under $250 million, provided these banks are judged to be well capitalized under the prompt corrective action capital standards, were found to be well managed at the most recent examination, are not subject to formal enforcement actions, and have not experienced a change in control during this period. The banks must also have been rated outstanding or good (satisfactory) at their last examination (a CAMELS composite rating of 1 or 2). Problem institutions are typically examined on a more frequent basis, with many examined as often as twice a year.

For banking organizations with more than one bank, the federal agencies, whenever possible, coordinate their examination schedules so that all of the banks are examined within much the same time frame. Moreover, Congress directed the agencies to develop a system by 1996 for deciding which agency will have lead examination responsibilities for a particular banking organization. The agencies have continued to work jointly to improve the coordination of examinations and supervision of institutions subject to multiple regulators and to develop common examination data bases and information systems. This coordination is becoming even more essential with the ongoing consolidation among major
banks and large complex banking organizations and with the emergence of financial holding companies that can conduct a broad range of financial activities.

State banking departments have their own examination procedures and schedules for state-chartered banks. To ease the examination burden and reduce supervisory overlap, state banking departments often share their state bank examination responsibilities with the FDIC and the Federal Reserve. This sharing might take the form of alternating examinations with the appropriate federal agency or performing joint or concurrent examinations with that agency.

**Bank holding company inspections**

Since the financial condition of a bank holding company or any of its subsidiaries might adversely affect the operations of subsidiary banks, the Federal Reserve assesses or inspects the condition of bank holding companies and financial holding companies. Much like the bank examination process, holding company inspections have become more risk focused, with more resources devoted to major organizations and to the more notable risk exposures. Bank holding company inspections are directed mainly at the relationships that could be detrimental to subsidiary banks, and the holding companies are expected to serve as a source of financial and managerial strength to their banking subsidiaries.

The major aspects of an inspection include an assessment of the financial condition of the parent organization, its banking subsidiaries, and any nonbanking subsidiaries; a review of intercompany transactions and relationships; an evaluation of the current performance of the company and its management; and a check of the company’s compliance with applicable laws, regulations, and commitments made to the Federal Reserve. While recent examination reports provide the main source of information on banking subsidiaries and other regulated affiliates, on-site evaluations are
often made of the financial condition of the bank holding company itself and significant nonbank subsidiaries.

Steps taken in a holding company inspection to review such items as assets, earnings, capital, and management are similar to that of a bank examination. However, particular attention is given to the level of debt carried by a bank holding company, the potential payment demands the debt places on bank earnings, and the success of the holding company in servicing its debt. All financial and managerial aspects of a bank holding company and its overall condition then are summarized and assigned a rating under the BOPEC rating system.

This rating system specifically looks at five aspects of a bank holding company's performance and condition:

- Bank subsidiaries
- Other (nonbank) subsidiaries
- Parent company
- Earnings consolidated
- Capital adequacy consolidated

Much like bank examination ratings, a company is rated from ‘1’ (best) to ‘5’ (weakest) on each of these aspects. The first three elements listed above are rated according to their contribution to the company's fundamental soundness. Consolidated earnings and capital adequacy are also important elements in the BOPEC rating system because of their critical role in the financial strength and support provided to the entire organization.

In addition to these five elements, a company is given a composite rating, which consists of both a financial and a managerial component. The financial composite rating reflects a company's overall performance under the five BOPEC elements and is measured on the same scale of ‘1’ to ‘5’. The managerial composite rating is based on a comprehensive evaluation of a company's management as determined by management's role in banking,
nonbanking, and parent company operations. This rating is either an ‘S’, ‘F’, or ‘U’, depending on whether management is judged to be satisfactory, fair, or unsatisfactory.

The Federal Reserve’s general approach and procedures in a holding company inspection can vary considerably, depending on the type of organization and its activities. For a large complex banking organization, many other authorities may be involved in the supervision of the affiliated banks and other subsidiaries. Consequently, the Federal Reserve must work closely with these agencies to coordinate supervisory plans, examinations and inspections, discussions with bank and holding company management, and any necessary enforcement actions. This coordinated supervision is becoming more specialized and tailored to individual organizations, and inspections and examinations are now more of a continuous process over the supervisory cycle. As an example, the supervision of large complex organizations often takes the form of a series of targeted examinations, which track individual business lines and risk exposures as they extend across the entire organization. These targeted reviews can then be incorporated into an overall assessment of the consolidated organization and its risk management practices.

In the case of financial holding companies, a number of other considerations are also important. As the “umbrella supervisor” of financial holding companies, the Federal Reserve Board has authority to supervise the overall organization. The Gramm-Leach-Bliley Act of 1999, however, imposes several limits on these supervisory powers. For instance, the Federal Reserve may not directly examine a financial subsidiary that is regulated by another authority, except under certain circumstances. Instead, the Federal

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41 Large complex banking organizations are generally those with a broad range of products and activities, operations that spread across multiple supervisory jurisdictions, and consolidated assets of $1 billion or more. In addition, these organizations are often structured and managed along business lines or functions that may spread across a number of different subsidiaries or legal entities, making close supervisory coordination critical in evaluating overall risk exposures.
Reserve must, to the fullest extent possible, rely on the examination reports of the other regulators and any information a financial subsidiary provides to the public and its direct supervisor. The Federal Reserve, moreover, is limited in its ability to impose capital requirements on regulated financial subsidiaries, take enforcement actions against such subsidiaries, or require financial subsidiaries to assist their depository institution affiliates.

The frequency of holding company inspections depends on the size and condition of a holding company and the complexity of its debt structure and nonbanking activities. Companies with more than $150 million in consolidated assets and that also have public debt or significant nonbank lending activities receive a full-scope inspection on an annual basis. In addition to this, the Federal Reserve typically undertakes a limited-scope or targeted inspection each year for major banking organizations and for other large organizations with serious problems. Smaller organizations are inspected on a less frequent basis unless holding company problems, adverse financial information, or ownership changes warrant closer attention. Furthermore, for companies that have less than $1 billion in assets, no public debt, and no significant nonbanking activities, Federal Reserve examiners are to perform a risk assessment, utilizing previous examination and inspection reports, other regulatory reports, and off-site surveillance information. These assessments can take the place of a full-scope inspection, provided no major concerns or problems are identified.

**Reporting requirements**

Banks must file various reports with their supervisors. Some reports, such as on insider loans, are used for specific regulatory
objectives, while others inform bank supervisors of a bank’s current condition and performance. Since the Report of Condition is a balance sheet of a bank, it is the basic report for supervisory purposes and provides the deposit information used for FDIC insurance assessments. Collected quarterly from all banks, the report provides a breakdown of a bank’s assets, liabilities, capital accounts, and off balance sheet activities on the last banking day of each quarter (See Figure 2 for the main schedule of the Report of Condition). The Report of Income lists a bank’s revenues, expenses, and net income, as well as such items as dividends and contributions to capital. This report is also required quarterly (See Figure 3 for the main schedule of the Report of Income). Other reports are required for such purposes as calculating reserve requirements, regulating bank holding company operations and foreign banking activities, and tracking changes in such areas as ownership and management structure, financial holding company activities, foreign lending exposures, and insider lending. In addition, problem institutions may be asked by their primary supervisor to file special reports on their overall condition and progress in restoring capital or improving asset quality.

Most bank reports are also available to the public and serve to give investors and bank customers information on a bank’s operations and performance. This information is particularly important for the major customers of a bank and for bank stockholders, note-holders, or holding company investors as they try to protect their financial interests and make new investment choices. Because such individuals can exert a strong influence on the operation of a bank, bank supervisors, as well as many investors, continue to examine means to further increase public disclosure in banking. Greater disclosure, in fact, could expand the role that private parties and bank reporting play in achieving supervisory objectives. In partic-

43 Beginning March 31, 2001, banks with domestic offices only will all file the same Report of Condition and Income. Banks with both domestic and foreign offices will file a slightly different report.
## Consolidated Report of Condition for Insured Commercial and State-Chartered Savings Banks for March 31, 2001

All schedules are to be reported in thousands of dollars. Unless otherwise indicated, report the amount outstanding as of the last business day of the quarter.

### Schedule RC—Balance Sheet

<table>
<thead>
<tr>
<th>Item</th>
<th>Column 1</th>
<th>Column 2</th>
<th>Column 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Cash and balances due from depository institutions (from Schedule RC-A):</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Noninterest-bearing balances and currency and coin</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b. Interest-bearing balances$</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Securities:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Held-to-maturity securities (from Schedule RC-B, column A)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b. Available-for-sale securities (from Schedule RC-B, column D)</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>3. Federal funds sold and securities purchased under agreements to trade.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Loans and lease financing receivables (from Schedule RC-C):</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Loans and leases held for sale</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b. Loans and leases, net of unearned income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c. LESS: Allowance for loan and lease losses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>d. Loans and leases, net of unearned income and allowance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Trading assets (from Schedule RC-D)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Premises and fixed assets (including capitalized leases)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Other real estate owned (from Schedule RC-M)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Investments in unconsolidated subsidiaries and associated companies (from Schedule RC-M)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9. Customers’ liability to this bank on acceptances outstanding</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. Intangible assets:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Goodwill</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b. Other intangible assets (from Schedule RC-M)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11. Other assets (from Schedule RC-P)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12. Total assets (sum of Items 1 through 11)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: This figure is referenced on page 127.
Regulation for Depositor Protection and Monetary Stability

Figure 2, continued

<table>
<thead>
<tr>
<th>Schedule RC—Continued</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Item</th>
<th>Dollar Amounts in Thousands</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>13.a.</td>
<td>Deposites (sum of (1) and (2))</td>
<td>3839</td>
<td>3230</td>
<td>2930</td>
</tr>
<tr>
<td>13.a.(1)</td>
<td>Noninterest-bearing</td>
<td>6636</td>
<td>6631</td>
<td>6432</td>
</tr>
<tr>
<td>13.a.(2)</td>
<td>Interest-bearing</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>13.a.(3)</td>
<td>In foreign offices, Edge and Agreement subsidiaries, and IBFs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14.</td>
<td>Federal funds purchased and securities sold under agreements to repurchase</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15.</td>
<td>Trading liabilities (from Schedule RC-D)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>16.</td>
<td>Other borrowed money (includes mortgage-backed securities and obligations under capitalized leases, (from Schedule RC-M)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>17.</td>
<td>Not applicable</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18.</td>
<td>Bank's liability on acceptances executed and outstanding</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>19.</td>
<td>Subordinated notes and debentures</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20.</td>
<td>Other liabilities (from Schedule RC-G)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>21.</td>
<td>Total liabilities (sum of items 13 through 20)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>22.</td>
<td>Minority interest in consolidated subsidiaries</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>23.</td>
<td>Perpetual preferred stock and related surplus</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>24.</td>
<td>Common stock</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>25.</td>
<td>Accumulated other comprehensive income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>26.a.</td>
<td>Retained earnings</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>27.</td>
<td>Other equity capital components</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>28.</td>
<td>Total equity capital (sum of items 21, 22, and 26)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Memorandum

To be reported with the March Report of Condition.

1. Indicate in the box at the right the number of the statement below that best describes the most comprehensive level of auditing work performed for the bank by independent external auditors as of any date during 2000.

- 1 = Independent audit of the bank conducted in accordance with generally accepted auditing standards by a certified public accounting firm which submits a report on the bank on or before the report date.
- 2 = Independent audit of the bank's parent holding company conducted in accordance with generally accepted auditing standards by a certified public accounting firm which submits a report on the bank's consolidated holding company (but not on the bank separately).
- 3 = Attestation on bank management's assertion on the effectiveness of the bank's internal control over financial reporting by a certified public accounting firm
- 4 = Directors' examination of the bank conducted in accordance with generally accepted auditing standards by a certified public accounting firm (may be required by state chartering authority).
- 5 = Directors' examination of the bank performed by other external auditors (may be required by state chartering authority).
- 6 = Review of the bank's financial statements by external auditors
- 7 = Compilation of the bank's financial statements by external auditors
- 8 = Other audit procedures (excluding tax preparation work)
- 9 = No external audit work

- Includes limited-life preferred stock and related surplus.
- Includes total demand deposits and noninterest-bearing time and savings deposits.
All Report of Income schedules are to be reported on a calendar year-to-date basis in thousands of dollars.

Schedule RI—Income Statement

<table>
<thead>
<tr>
<th></th>
<th>1st Qtr</th>
<th>2nd Qtr</th>
<th>3rd Qtr</th>
<th>4th Qtr</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Interest income:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Item 1.a.(6)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(1) Loans secured by real estate</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2) Commercial and industrial loans</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(3) Loans to individuals for household, family, and other personal expenditures</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Credit cards</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b. Other (includes single payment, installment, all student loans, and revolving credit plans other than credit cards)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(4) Loans to foreign governments and official institutions</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(5) All other loans</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b. Interest income on balances due from depository institutions</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c. Interest income on balances due from nondepository institutions</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>d. Interest income on balances due from the U.S. Treasury</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>e. Interest income on balances due from the Federal Home Loan Bank</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>f. Interest income on balances due from the Federal National Mortgage Association</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>g. Interest income on balances due from the Federal Home Loan Bank</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>h. Total interest income (sum of items 1.a through 1.g)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Interest expense:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Interest on deposits:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(1) Transaction accounts (NOW accounts, ATS accounts, and telephone and unauthorized transfer accounts)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2) Nontransaction accounts:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Savings deposits</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b. Time deposits of $100,000 or more</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c. Time deposits of less than $100,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>d. Time deposits of less than $10,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>e. Money market accounts</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>f. Commercial money market accounts</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>g. Other (includes time deposits of less than $10,000 and other accounts)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b. Expense of federal funds purchased and securities sold under agreements to repurchase</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c. Interest on subordinated notes and debentures</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>d. Interest on subordinated notes and debentures</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>e. Total interest expense (sum of items 2.a through 2.g)</td>
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<td></td>
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</table>

Note: This figure is referenced on page 127.
### Schedule RI—Continued

<table>
<thead>
<tr>
<th>Year-to-date</th>
<th>2005</th>
<th>2004</th>
<th>2003</th>
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<tbody>
<tr>
<td>3. Net interest income (item 1.h minus 2.e)</td>
<td>$X$</td>
<td>$Y$</td>
<td>$Z$</td>
</tr>
<tr>
<td>4. Provision for loan and lease losses</td>
<td>$A$</td>
<td>$B$</td>
<td>$C$</td>
</tr>
<tr>
<td>5. Noninterest income:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Income from fiduciary activities</td>
<td>$D$</td>
<td>$E$</td>
<td>$F$</td>
</tr>
<tr>
<td>b. Service charges on deposit accounts</td>
<td>$G$</td>
<td>$H$</td>
<td>$I$</td>
</tr>
<tr>
<td>c. Trading revenue</td>
<td>$J$</td>
<td>$K$</td>
<td>$L$</td>
</tr>
<tr>
<td>d. Provision for loan and lease losses</td>
<td>$M$</td>
<td>$N$</td>
<td>$O$</td>
</tr>
<tr>
<td>e. Venture capital revenue</td>
<td>$P$</td>
<td>$Q$</td>
<td>$R$</td>
</tr>
<tr>
<td>f. Net servicing fees</td>
<td>$S$</td>
<td>$T$</td>
<td>$U$</td>
</tr>
<tr>
<td>g. Net securitization income</td>
<td>$V$</td>
<td>$W$</td>
<td>$X$</td>
</tr>
<tr>
<td>h. Insurance commissions and fees</td>
<td>$Y$</td>
<td>$Z$</td>
<td>$[AA]$</td>
</tr>
<tr>
<td>i. Loan and other credit-related fees</td>
<td>$BB$</td>
<td>$CC$</td>
<td>$DD$</td>
</tr>
<tr>
<td>j. Net gains (losses) on sales of loans</td>
<td>$EE$</td>
<td>$FF$</td>
<td>$GG$</td>
</tr>
<tr>
<td>k. Net gains (losses) on sales of other real estate owned</td>
<td>$HH$</td>
<td>$II$</td>
<td>$JJ$</td>
</tr>
<tr>
<td>l. Net gains (losses) on sales of other assets (excluding securities)</td>
<td>$KK$</td>
<td>$LL$</td>
<td>$MM$</td>
</tr>
<tr>
<td>m. Other noninterest income</td>
<td>$NN$</td>
<td>$OO$</td>
<td>$PP$</td>
</tr>
<tr>
<td>n. Total noninterest income (sum of items 5.a through 5.m)</td>
<td>$QQ$</td>
<td>$RR$</td>
<td>$SS$</td>
</tr>
<tr>
<td>6. a. Realized gains (losses) on held-to-maturity securities</td>
<td>$TT$</td>
<td>$UU$</td>
<td>$VV$</td>
</tr>
<tr>
<td>b. Realized gains (losses) on available-for-sale securities</td>
<td>$WW$</td>
<td>$XX$</td>
<td>$YY$</td>
</tr>
<tr>
<td>7. Noninterest expense:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Salaries and employee benefits</td>
<td>$ZZ$</td>
<td>$AA$</td>
<td>$BB$</td>
</tr>
<tr>
<td>b. Expenses of premises and fixed assets (net of rental income)</td>
<td>$CC$</td>
<td>$DD$</td>
<td>$EE$</td>
</tr>
<tr>
<td>c. Amortization expense of intangible assets (excluding goodwill)</td>
<td>$FF$</td>
<td>$GG$</td>
<td>$HH$</td>
</tr>
<tr>
<td>d. Other noninterest expense</td>
<td>$II$</td>
<td>$JJ$</td>
<td>$KK$</td>
</tr>
<tr>
<td>n. Total noninterest expense (sum of items 7.a through 7.d)</td>
<td>$LL$</td>
<td>$MM$</td>
<td>$NN$</td>
</tr>
<tr>
<td>8. Income (loss) before income taxes, goodwill charges, extraordinary items, and other adjustments (item 8 plus or minus items 6.a, 6.b, and 7.e)</td>
<td>$OO$</td>
<td>$PP$</td>
<td>$QQ$</td>
</tr>
<tr>
<td>9. Applicable taxes (item 9)</td>
<td>$RR$</td>
<td>$SS$</td>
<td>$TT$</td>
</tr>
<tr>
<td>10. Income (loss) before goodwill charges, extraordinary items, and other adjustments (item 8 minus item 9)</td>
<td>$UU$</td>
<td>$VV$</td>
<td>$WW$</td>
</tr>
<tr>
<td>11. Goodwill charge</td>
<td>$XX$</td>
<td>$YY$</td>
<td>$ZZ$</td>
</tr>
<tr>
<td>12. Income (loss) before extraordinary items and other adjustments (item 10 minus item 11)</td>
<td>$AA$</td>
<td>$BB$</td>
<td>$CC$</td>
</tr>
<tr>
<td>13. Extraordinary items and other adjustments, net of income taxes*</td>
<td>$DD$</td>
<td>$EE$</td>
<td>$FF$</td>
</tr>
<tr>
<td>14. Net income (loss) (sum of items 12 and 13)</td>
<td>$GG$</td>
<td>$HH$</td>
<td>$II$</td>
</tr>
</tbody>
</table>

* Describe on Schedule RI-E—Explanations

1. For banks required to complete Schedule RI, Memorandum items 8.a through 8.d, trading revenue reported in Schedule RI, item 5.c, must equal the sum of Memorandum items 8.a through 8.d, trading revenue.
ular, banking supervisors and others have been looking at ways to improve disclosures on asset quality and concentrations, other significant risk exposures, derivative instruments, various off balance sheet activities of banks, and the fair market value of major banking assets and liabilities.

Apart from supervisory reports, banks must also file Bank Secrecy Act reports on large currency transactions with customers. These Currency Transaction Reports are routinely used by the Treasury Department and Internal Revenue Service in various criminal and tax investigations and prosecutions. The reports have most prominently been associated with attempts to track money laundering from the drug trade and other illegal activities.

Under the Bank Secrecy Act, banks must file a report on each single or multiple currency transaction totaling $10,000 or more. Banks, though, are not required to file reports on transactions with other depository institutions, U.S. governmental or state authorities, and certain types of businesses where the reports would have little law enforcement value. Depending on the circumstances, banks may also be able to exempt customary transactions with selected businesses and with established customers that appear to be conducting legitimate operations. Banks are to report any suspicious transactions even though they may not fall within the reporting standards.

**Surveillance and early warning systems**

Federal bank supervisors use surveillance and early warning systems to monitor a bank’s condition and performance between examinations and indicate when special examinations or emergency measures might be necessary. These surveillance systems are constructed primarily from previous examination information and the regular reports filed by banks and bank holding companies. In

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general, the systems calculate a number of financial ratios, including capital ratios, disaggregated asset and liability ratios, and income ratios. Statistical comparisons are then made between the financial ratios and trends for a particular bank and those of other banks in order to judge whether that bank’s condition is improving or declining.

Bank surveillance and monitoring efforts are also beginning to take advantage of various market measures of bank conditions, including bank stock prices, debt yields and ratings, and rates on uninsured deposits. Changes and volatility in these measures can thus provide valuable insights into how investors and other market participants view a bank’s prospects.

Given the large resource requirements of on-site examinations, surveillance systems will continue to be important in monitoring banks between examinations and in scheduling the next examination. Surveillance and monitoring systems could play an even larger role in the future to the extent that bank disclosures become more detailed and regulators find ways to incorporate a wider range of information into the surveillance process.

**Enforcement actions and penalties**

The federal banking agencies can initiate a number of enforcement actions and penalties to direct banks, holding companies, and their management to correct problems and prevent further deterioration. In general, the federal agency supervising the institution or company has the authority to pursue enforcement actions. However, the FDIC has backup enforcement powers for any insured institution and may recommend that an institution’s primary supervisor take enforcement steps. Under certain conditions, the FDIC may even initiate such steps itself, provided the primary supervisor fails to do so or an emergency situation exists.

Although the agencies differ somewhat in their use of the various actions, enforcement steps are most commonly taken for one
of two reasons. First, an institution may be undercapitalized, and its federal supervisor will issue a directive under the prompt corrective action guidelines. Second, enforcement actions may be pursued after unsafe, unsound, or illegal practices are detected during a bank examination or holding company inspection or in response to other information. Such practices might include poor loan administration, abnormal risk taking, weak management, excessive dividend payments, and violations of banking laws. The severity of these practices will govern the type of action taken.

For banking problems that are not severe and do not involve abusive practices, federal banking agencies may pursue any one of several informal actions or voluntary agreements. These include verbal or written commitments by bank officials to resolve identified problems, board resolutions that record such commitments, and memoranda of understanding that reflect an agreement between a supervisory agency and a bank’s directors. Because these actions represent voluntary agreements, they are generally used in cases where bank management can be expected to take the necessary corrective steps.

For more severe violations and unsafe or abusive practices, banking agencies can issue formal and legally enforceable actions. These actions encompass written agreements, cease and desist orders, and suspension, prohibition, or removal actions. Under provisions amended by Congress in 1989, these actions can be directed toward depository institutions or any “institution-affiliated party.” The term institution-affiliated party not only includes bank directors, officers, employees, and controlling shareholders, but it can also extend to bank consultants, joint venture

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45 Since prompt corrective action directives are discussed on pages 90–95, this section will focus on the basic framework for taking enforcement actions and will also cover enforcement actions issued for other reasons.

partners, and independent contractors for a bank, such as attorneys, appraisers, or accountants. Federal agencies must publish and make available to the public any formal actions they pursue and any modifications or terminations of these actions.

Cease and desist orders can be issued when an agency has reasonable cause to believe a depository institution or any institution-affiliated party has engaged or is about to engage in an unsafe or unsound practice or is in violation of a law, rule, regulation, written condition, or written agreement. A cease and desist order will direct the institution or named parties to stop engaging in the specific practices or violations. In addition, the order may require affirmative action to correct any resulting conditions. Such action can include making restitution for unjust gains or reckless behavior, restricting the institution's growth, disposing of any loans or assets related to the institution's problems, rescinding agreements or contracts, employing qualified management or personnel, and other steps the agency deems appropriate.

An agency may issue final or temporary cease and desist orders. A final order provides an opportunity for an administrative hearing before it becomes effective. In contrast, temporary orders take effect immediately. However, to issue a temporary order, an agency must further find that the violation or practice is likely to either cause insolvency, significantly dissipate assets or earnings, weaken the institution's condition, or threaten depositors. Temporary orders can also be issued when an institution's records are so incomplete or inaccurate that its financial condition cannot be assessed. Administrative hearings can be held while a temporary order remains effective, and both final and temporary orders can be appealed within the federal court system.

47 12 U.S.C. §1818(b), 1818(c).

Written agreements are formal contracts between an institution and its federal supervisory agency regarding the institution's operations.
Federal banking agencies may also remove or prohibit the participation of selected individuals in an institution’s operations. To do so, the agencies must find violations of laws, regulations, or supervisory orders; unsafe or unsound practices; or breaches of fiduciary duty. Such actions must involve loss or potential damage to the institution, possible harm to depositors, or financial gain or other benefit to the individual. Furthermore, the actions must reflect personal dishonesty or willful disregard for the institution’s safety. Until removal proceedings are completed, the agencies may suspend individuals from participating in banking operations. The removal, suspension, and prohibition provisions further prevent individuals from associating with any other depository institution without written agency consent.

In addition to supervisory orders, federal banking agencies may assess civil money penalties for institutions or parties violating laws, regulations, or supervisory enforcement actions; engaging in unsafe or unsound practices; or breaching fiduciary duties. These penalties have an initial ceiling of $5,000 per day, but they may escalate to $25,000 a day for recklessly engaging in an unsafe or unsound practice. The higher penalty may also be imposed when a pattern of misconduct is apparent, the institution suffers more than a minimal loss, or the party derives pecuniary gains or other benefits from the violations or unsafe practices. A maximum penalty of $1 million a day or one percent of a bank’s assets, whichever is less, applies to violations or actions done knowingly and which knowingly or recklessly cause a substantial loss to the institution or substantial gain to the individual. Criminal penalties may be sought for violations of removal, prohibition, and suspension orders; intentional violations of the Bank Holding Company

Act; and bank criminal offenses, such as bribery, embezzlement, or falsifying bank records.

A final group of enforcement steps includes the termination of deposit insurance, appointment of bank conservators, and divestment of activities. Termination of insurance and appointment of a conservator are actions that are used only in the most serious situations and after other supervisory alternatives are exhausted, while divestment of activities is an enforcement step that federal regulators may take under the Gramm-Leach-Bliley Act of 1999. To terminate an institution's insurance through a final order, the FDIC must find unsafe or unsound financial conditions or practices or a violation of any law, regulation, or supervisory order or agreement. After insurance termination, insured deposits, less any subsequent withdrawals, remain insured for a period of at least six months, but no more than two years.

The Comptroller of the Currency and most state banking agencies may appoint a conservator to take over a problem bank and prevent any further dissipation of its assets pending final resolution steps. The Comptroller may establish a conservatorship over a national bank for a variety of reasons, although in most cases the bank must either be unable to meet depositor demands or be about to deplete its capital with no reasonable hope of recovery. A conservator may engage in normal banking operations, subject to any conditions the Comptroller might impose.

In addition, a federal banking agency may, with the concurrence of the FDIC, appoint a conservator over a critically undercapitalized bank it supervises. A federal banking agency supervising a state bank or the FDIC may also appoint a conservator under certain circumstances to facilitate the prompt corrective action provisions or to prevent losses to the bank insurance fund.

Under the Gramm-Leach-Bliley Act of 1999, the Federal Reserve Board and the Comptroller of the Currency may order financial holding companies and national banks to divest or cease certain activities if they fall out of compliance with the act and fail
to correct the deficiencies. For example, if a depository institution in a financial holding company fails to meet the well-capitalized or well-managed standards of the act and this condition is not corrected within 180 days, the Federal Reserve may order the company to divest control of any subsidiary depository institution or cease engaging in financial activities authorized by the act. Similarly, if a national bank or any insured depository institution affiliate fails to meet such standards and make corrections within 180 days, the Comptroller of the Currency may order the bank to divest control of any financial subsidiary. Federal Reserve regulations extend comparable provisions to state member banks with financial subsidiaries.

**FDIC assessments and policies**

The deposit insurance system is funded by assessments against the deposits at insured banks. These assessments help cover the FDIC’s operating expenses and deposit insurance losses, and any remaining amounts go toward building up FDIC insurance fund reserves.

Because of declining insurance reserves, several large bank failures, and other banking problems in the 1980s, Congress established a new schedule in 1989 for FDIC insurance assessment rates. This schedule allowed for higher rates in order to strengthen the insurance fund and, over time, bring it up to a Congressionally mandated level of 1.25 percent of estimated insured deposits, which was reached in 1995. The Federal Deposit Insurance Corporation Improvement Act of 1991 further required the FDIC to establish a risk-based deposit insurance assessment system. Under this system, rates are to be linked to the probability that the insurance fund would incur a loss from a particular bank.

In its risk-based assessment system, the FDIC puts individual institutions into one of nine risk categories, based on an institution’s placement into one of three capital subgroups and one of three supervisory subgroups. The three capital subgroups corre-
spond to whether an institution is well capitalized, adequately capitalized, or undercapitalized according to the current capital standards. The three supervisory subgroups are based on an institution’s last examination rating, other relevant supervisory and financial information, and emerging risk characteristics. To be in the top supervisory subgroup, an institution’s condition generally must correspond to a composite examination rating of ‘1’ or ‘2’. The next subgroup corresponds to ‘3’-rated institutions, while the last group primarily consists of ‘4’- and ‘5’-rated institutions.

Since 1996, FDIC assessment rates have ranged from 0 percent for banks in the top capital and supervisory subgroups to .27 percent of total assessable deposits for banks in both the bottom capital and supervisory subgroups. Banks with 97 percent of the deposit assessment base qualified for the 0 percent insurance premium for the second half of 2000, while less than 0.1 percent of all banks (8 banks) were paying the highest rate (.27 percent). At year-end 1999, the bank insurance fund had a $29.4 billion balance, which left a reserve ratio of 1.36 percent of insured deposits.

Under its insurance powers, the FDIC has responsibility for the insured depositors at failed banks. The FDIC can protect these depositors either by paying off deposits or arranging for them to be transferred to or assumed by another bank. In addition, the FDIC can take a number of other steps to protect depositors and

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49 The FDIC assigns banks to supervisory subgroups based on a number of different factors. The FDIC uses a statistical model to predict a current composite examination rating for each bank based on its most recent financial data and the estimated relationship derived from previous examination ratings and corresponding financial information. Before a bank is placed in a supervisory subgroup, this predicted rating is then compared to other information on the bank, including the results of its last examination and any additional supervisory or financial information. In addition, the FDIC has added another step to this process to identify banks in the top supervisory category that might more appropriately be placed in a lower category due to certain emerging risk characteristics and concerns about their risk-management practices. The FDIC identifies such banks through supplemental screens, which look at rapid bank growth rates, concentrations of high risk assets, high-yield and high-risk loans, and rapid changes in business mix, and through conversations with the primary supervisor about a bank’s risk-management practices.
resolve troubled banks, including bridge banks and FDIC financial assistance. 50

In choosing which of these options to use, the FDIC is required to use the method that will result in the least cost to the insurance fund. Moreover, the FDIC is specifically prohibited from taking any steps to protect uninsured depositors if such actions would increase losses to the insurance fund. The only exception to these least cost provisions is in emergency situations where compliance with the provisions “would have serious adverse effects on economic conditions or financial stability.” 51 Such exceptions would have to be approved by two-thirds of the FDIC Board, two-thirds of the Federal Reserve Board, and the Secretary of the Treasury (in consultation with the President).

In a deposit payoff at a failed bank, the FDIC makes direct payments on all insured deposits, currently up to $100,000 per depositor. In a deposit transfer, another bank takes over the insured deposits of the failed bank. In both deposit payoffs and transfers, depositors with uninsured accounts are given a claim on the receivership. They will receive proceeds from the FDIC’s liquidation of the bank on a proportionate basis after administrative expenses of the receiver and secured claims on the bank have been covered, but before foreign deposit claims and the obligations of other creditors are satisfied. 52

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50 The FDIC’s authority with respect to failing banks is largely derived from 12 U.S.C. §1821. Failing banks are closed by their chartering authority — the Comptroller of the Currency for national banks and the appropriate state banking department or agency for state banks. Because of its insurance role and resources, the FDIC must be appointed as receiver for national banks and nearly always is appointed receiver for state banks by the state banking authorities. If necessary to reduce losses to the deposit insurance fund, the FDIC also may appoint itself as conservator or receiver for an insured bank after consultation with the appropriate state and federal agencies.


52 Subordinated debtholders and stockholders would not receive any proceeds from liquidation except when funds still remained after the general creditors had been fully reimbursed. Other provisions could also affect stockholder interests at failing banks. Since 1989, depository institutions that are affiliated with an insured institution in default or receiving FDIC assistance may be required to reimburse the FDIC for any related costs.
In a deposit assumption, the failed bank is acquired by another party or merged with another institution. The acquiring group takes all or a portion of the failed bank’s assets along with all of its deposits, both insured and uninsured. A purchase and assumption transaction consequently protects all depositors and maintains existing customer relationships. Because of these benefits, the FDIC attempts to use purchase and assumption transactions whenever they do not result in added costs for the insurance fund.

For a bank in default or in danger of default, the FDIC also may choose to reorganize its operations within a “bridge bank” to be chartered by the Comptroller of the Currency. The primary purpose of a bridge bank is to give the FDIC time to arrange a successful sale or merger of a closed or failing bank. Bridge banks must either be less costly to the FDIC than a liquidation, essential for providing adequate community banking services, or in the best interest of depositors. A bridge bank is managed by a board of directors appointed by the FDIC, and it may take over any assets or deposits from its predecessor that the FDIC deems appropriate. Bridge banks exercise the same corporate powers held by national banks. However, their operations must be terminated through sale or closure within two years, unless the FDIC extends their status for up to three more years.

The FDIC may provide financial assistance to banks in order to prevent their failure, reopen closed banks, or lessen the FDIC’s risk during unstable financial conditions. The FDIC may also assist organizations that are acquiring or merging with these banks. This assistance can involve the FDIC making loans to or placing deposits in a bank, purchasing its assets or securities, assuming liabilities, or making contributions. For an acquiring organization, the FDIC may provide assistance through loans, contributions,

53 12 U.S.C. §1821(n). Similarly, a new national bank can be chartered under 12 U.S.C. §1821(m) to take over the insured deposits of a bank in default.

deposits, security or asset purchases, deposit assumptions, or guarantees against loss. This assistance is at the sole discretion of the FDIC and must entail the least cost to the insurance fund of all possible approaches.

Annual independent audits and related reporting requirements

In addition to oversight by supervisory agencies, many banks also must be audited annually by independent public accountants. Section 112 of the Federal Deposit Insurance Corporation Improvement Act of 1991, as implemented, requires insured depository institutions with total assets exceeding $500 million to submit audited annual reports to the FDIC and to the appropriate state and federal regulatory agencies. This audit requirement is intended to help banks identify problems at an early stage and to bring about more stringent internal controls and more accurate reporting.

These annual reports must be made available for public inspection and must contain three items. One item is an audited annual financial statement and the independent public accountant’s report on this statement. A second item is a report and assessment by bank management on the effectiveness of the bank’s internal controls and its procedures for complying with safety and soundness regulations. The final item is the public accountant’s report evaluating the bank’s internal control structure and the assertions made by management. The financial statements must reflect generally accepted accounting principles. A consolidated bank holding company statement may be substituted for those of its subsidiary banks under certain circumstances.

The 1991 legislation also requires that each insured bank establish an audit committee comprised of outside directors who are

Many states also have their own set of internal and external audit requirements for state banks.
independent of the bank’s management. The duties of this committee include reviewing the annual reports with bank management and the independent public accountant. For institutions with over $3 billion in assets, at least two individuals on the audit committee must have banking or related financial management expertise, and the committee must have access to its own legal counsel.

**SUMMARY**

A variety of laws, regulations, and supervisory practices have evolved to protect depositors and limit the exposure of the deposit insurance system. With deposit insurance, most depositors are fully protected in the event that a bank should fail. Consequently, bank failures need not mean losses for depositors or economic disruption in a community or region. At the same time, though, banking problems and the risk exposure of the banking industry must be controlled if deposit insurance is to be a viable system and public confidence is to be maintained in banking.

The current regulatory and supervisory framework involves prohibitions and restrictions on some activities that could invite abusive or excessively risky actions. It also includes close supervisory oversight of key aspects of a bank’s operations and policy making functions. These regulatory provisions and supervisory steps are supported as well by a wide range of enforcement powers for the banking agencies. Finally, state and federal banking agencies have a number of options for dealing with troubled and failed banks. These options allow the agencies to choose a solution most consistent with depositor protection concerns, financial stability issues, and deposit insurance costs.

This supervisory system is necessarily becoming more complex over time as banks take on additional activities and risks and as the financial system develops along many new and innovative paths. Over the past decade, for example, supervisory changes have included risk-based capital requirements, prompt corrective action
enforcement steps, early closure of failing banks, risk-based deposit insurance premiums, and risk-focused examinations. These changes represent an effort to protect depositors while controlling the cost and risk exposure in the federal deposit insurance system. In many cases, they also represent an effort to reduce the burden of regulation for soundly operated banks, while directing more supervisory attention to the banks most likely to encounter trouble. In addition, recent regulatory changes have sought to increase the role of market discipline in the safe and sound operation of banks. Further changes in regulation will be inevitable as banks pursue new activities and as legislators and regulators grapple with the question of what level of oversight will protect depositors adequately without needlessly restricting banks or threatening deposit insurance.