# *Banking Supervision and Regulation*

The 1990s have been a period of significant growth in the Federal Reserve's responsibilities for banking oversight as well as change in its approach to such oversight. Much of the increased responsibility stems from 1991 legislation in which the Congress expanded the Federal Reserve's supervisory authority over the U.S. activities of foreign banking organizations. The purpose of the bill was to fill certain gaps in the supervision and regulation of such activities and to ensure that U.S. banking policies are applied fairly and consistently to all entities that conduct banking in the United States. The legislation, the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA), involved 400 institutions with assets of more than $700 billion.[1]

All told, from 1990 through 1995, aggregate assets under the Federal Reserve's supervision more than doubled, and despite a dramatic consolidation within the U.S. banking system during that period, the number of institutions the Federal Reserve supervised remained relatively stable, at approximately 7,000. Among state member banks, which account for a large portion of the Federal Reserve's oversight responsibility, the number of state member banks remained at around 1,000 between 1990 and 1995, while the assets of such institutions grew 77 percent. And although the number of bank holding companies and their nonbank subsidiaries declined between 1990 and 1995, the assets of these groups grew markedly over the period (54 percent); most of the asset growth was in the "section 20" companies, nonbank subsidiaries engaged in underwriting corporate securities.

The growth of the Federal Reserve's supervisory responsibilities has increased the demands on the System's resources. In response, the Federal Reserve has, over the past few years, adapted its approach to the supervisory process to make it more focused on risk, more sensitive to the burden it places on institutions, and more cost-effective.

In the past, examinations and inspections have focused on regulatory compliance and on assessing the financial strength of an institution by reconciling accounts, reviewing individual transactions, and analyzing the institution's financial condition. In recent years, however, improved technology and financial innovations have enabled banks to develop financial products that can quickly alter their balance sheets and change their exposure to risk. As a result, supervisory authorities can no longer rely solely on periodic assessments of an institution's balance sheet position at a point in time, but must ensure that the institution has adequate procedures to identify, measure, monitor, and control its risk exposure.

Important changes have been implemented or are in the process of being adopted based on a fundamental review of the Federal Reserve's examination procedures. These changes include

1. Before passage of FBSEA, primary responsibility for supervising and examining the U.S. branches and agencies of foreign banking organizations lay with the licensing agencies—the states or the Office of the Comptroller of the Currency. In carrying out its responsibilities for foreign banking organizations before FBSEA, the Federal Reserve relied mainly on examinations conducted by the states.

- Refocusing on the areas of greatest risk to a bank and on an assessment of the bank's risk-management procedures and capabilities
- Customizing examinations to fit the size, activities, and risks of the institution
- Developing a streamlined examination program for smaller institutions
- Adapting the existing approach to examination, which is based on an institution's legal structure, to a framework based on the institution's functional or business lines
- Conducting a greater portion of an examination off-site
- Improving communications with examined institutions
- Cooperating more closely with internal auditors and outside accountants
- Placing greater emphasis on market discipline, and using positive incentives to encourage prudent oversight by management.

The Federal Reserve has adopted a risk-focused approach to examinations as the principal vehicle for implementing these changes. The risk-focused approach highlights the importance of the management process for identifying, measuring, monitoring, and controlling risk. It gives examiners more flexibility in planning and conducting examinations. The risk-focused approach also places more attention on an institution's internal controls and on analysis and planning before the on-site examination begins.

## Scope of Responsibilities for Supervision and Regulation

The Federal Reserve is the federal supervisor and regulator of all U.S. bank holding companies and of state-chartered commercial banks that are members of the Federal Reserve System. In overseeing these organizations, the Federal Reserve primarily seeks to promote their safe and sound operation and their compliance with laws and regulations, including the Bank Secrecy Act and consumer and civil rights laws.[2] The Federal Reserve also examines the following specialized activities of these institutions: information systems, fiduciary activities, mutual fund activities, government securities dealing and brokering, municipal securities dealing, securities clearing activities, and securities underwriting and dealing through special subsidiaries.

The Federal Reserve also has responsibility for the supervision of (1) all Edge Act corporations and agreement corporations, (2) the international operations of state member banks and U.S. bank holding companies, and (3) the operations of foreign banking companies in the United States.[3]

The Federal Reserve exercises important regulatory influence over the entry into, and the structure of, the U.S. banking system through its administration of the Bank Holding Company Act, the Bank Merger Act for state member

2. The Board's Division of Consumer and Community Affairs is responsible for coordinating the Federal Reserve's supervisory activities with regard to the compliance of banking organizations with consumer and civil rights. To carry out this responsibility, the Federal Reserve specifically trains a number of its bank examiners to evaluate institutions with regard to such compliance. The chapter of this REPORT covering consumer and community affairs describes these regulatory responsibilities. Compliance with other statutes and regulations, which is treated in this chapter, is the responsibility of the Board's Division of Banking Supervision and Regulation and the Reserve Banks, whose examiners also check for safety and soundness.

3. Edge Act corporations are chartered by the Federal Reserve, and agreement corporations are chartered by the states, to provide all segments of the U.S. economy with a means of financing international trade, especially exports.

banks, and the Change in Bank Control Act for bank holding companies and state member banks. Also, the Federal Reserve is responsible for imposing margin requirements on securities transactions. In carrying out these responsibilities, the Federal Reserve coordinates its supervisory activities with other federal and state regulatory agencies and with the bank regulatory agencies of other nations.

## Supervision for Safety and Soundness

To ensure the safety and soundness of banking organizations, the Federal Reserve conducts on-site examinations, and inspections and off-site surveillance and monitoring; it also undertakes enforcement and other supervisory actions.

### *Examinations and Inspections*

The Federal Reserve conducts *examinations* of state member banks, branches and agencies of foreign banks, Edge Act corporations, and agreement corporations. Because many elements reviewed at bank holding companies and their nonbank subsidiaries differ from bank examinations, the Federal Reserve conducts *inspections* of holding companies and their subsidiaries. Pre-examination planning and on-site review of operations are integral parts of ensuring the safety and soundness of financial institutions. Regardless of whether it is an examination or inspection, the review entails (1) an assessment of the quality of the processes in place to identify, measure, monitor and control risk exposures, (2) an appraisal of the quality of the institution's assets, (3) an evaluation of management which includes an assessment of internal policies, procedures, controls, and operations, (4) an assessment of the key financial factors of capital, earnings, asset and liability management, liquidity, and sensitivity to market risk, and (5) a review for compliance with applicable laws and regulations.

### *State Member Banks*

At the end of 1996, 1,014 state-chartered banks were members of the Federal Reserve System (excluding nondepository trust companies and private banks). These banks represented about 11 percent of all insured commercial banks and held about 25 percent of all insured commercial bank assets.

The guidelines for Federal Reserve examinations are fully consistent with section 10 of the Federal Deposit Insurance Act as amended by section 111 of the Federal Deposit Insurance Corporation Improvement Act of 1991, and by the Riegle Community Development and Regulatory Improvement Act of 1994. A full-scope, on-site examination is required at least once during each twelve-month period for all depository institutions; however, certain well-capitalized and well-managed institutions with assets of less than $250 million may be examined every eighteen months.

During 1996, the Federal Reserve Banks conducted 606 examinations (some of them jointly with the state agencies), and state banking departments conducted 324 independent required examinations.

### *Bank Holding Companies*

At year-end 1996, the number of bank holding companies totaled 5,998. These organizations controlled 7,213 insured commercial banks and held approximately 93 percent of the assets of all insured commercial banks in the United States.

Federal Reserve guidelines call for annual inspections of large bank holding companies and smaller companies with significant nonbank assets. Small companies (those with assets less than $150 million) that do not have problems are selected for inspection on a sample basis, and medium-sized companies ($150 million to $500 million in assets) that do not have problems are inspected on a three-year cycle. The inspection focuses on the operations of the parent holding company, its nonbank subsidiaries, and the overall condition of the consolidated organization.

In judging the financial condition of subsidiary banks, Federal Reserve examiners consult the examination reports of the federal and state banking authorities that have primary responsibility for the supervision of these banks, thereby minimizing duplication of effort and reducing the burden on banking organizations. In 1996 the Federal Reserve inspected 1,674 bank holding companies. Altogether, Federal Reserve examiners conducted 1,922 bank holding company inspections, 149 of which were conducted off-site, and state examiners conducted 73 independent inspections.

## Enforcement Actions, Civil Money Penalties, and Suspicious Activity Reporting

In 1996, the Federal Reserve Banks recommended, and members of the Board's staff initiated and worked on, 133 enforcement cases involving 285 separate actions, such as cease and desist orders, written agreements, removal and prohibition orders, and civil money penalties. Of these, 66 cases involving 129 actions were completed by year-end.

Of particular note was the action that the Board of Governors took, in conjunction with state bank supervisory authorities in New York and California, against the Bangkok Metropolitan Bank, PCL, Bangkok, Thailand, which resulted in the bank's consent to terminate its U.S. banking operations. The action arose from serious unsafe and unsound banking practices and violations of law, including misleading and false statements made to regulatory officials, creation of false records, diversion of loan proceeds benefitting insiders, and extensions of credits to nominee borrowers.

In other significant matters, the Board of Governors assessed civil money penalties totaling $5.9 million, including a $3.5 million fine against a foreign bank for violations, by its section 20 subsidiary, of the Board of Governors' revenue limit, and a $300,000 fine against a foreign bank and one of its U.S. branches based on their lack of compliance with the Bank Secrecy Act and with an existing written agreement. Two cases involving fines totaling $1.7 million are under appeal in federal courts.

The Board of Governors also continued to address the misconduct of some former Bankers Trust officials who were involved with improper transactions involving leveraged derivatives; the Board issued consent orders limiting, among other things, the individuals' ability to market such transactions at other banking organizations and by assessing fines.

All final enforcement orders issued by the Board of Governors and all written agreements executed by the Federal Reserve Banks in 1996 are available to the public. In addition to formal enforcement actions, the Federal Reserve Banks completed eighty-four informal enforcement actions, such as memorandums of understanding and resolutions from the board of directors.

The Federal Reserve adopted an interagency rule, effective April 1, 1996, that simplifies the process for reporting suspected crimes and suspicious activities involving money laundering or the Bank Secrecy Act. The new reporting system enables a banking organization to report such activity by filing a single form, the interagency Suspicious Activity Report, with the Department of the Treasury's Financial Crimes Enforcement Network. The report goes into a computer database accessible by all appropriate federal and state banking and law enforcement authorities.

## Specialized Examinations

The Federal Reserve conducts specialized examinations of banking organizations regarding electronic data processing, fiduciary activities, government securities dealing and brokering, municipal securities dealing, securities clearing, and securities underwriting and dealing through so-called section 20 subsidiaries. The Federal Reserve also reviews state member banks and bank holding companies that act as transfer agents.

### *Electronic Data Processing*

Under the Interagency EDP Examination Program, the Federal Reserve examines the electronic data processing (EDP) activities of state member banks, U.S. branches and agencies of foreign banks, Edge Act and agreement corporations and independent data centers that provide EDP services to these institutions. During 1996, the Federal Reserve conducted 411 EDP examinations. The Federal Reserve also was the lead agency on four examinations of large Multiregional Data Processing Servicers examined on an interagency basis with the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

### *Fiduciary Activities*

The Federal Reserve has supervisory responsibility for institutions that hold more than $7.3 trillion of discretionary and nondiscretionary assets in various fiduciary capacities. This group of institutions includes 319 state-chartered member banks and trust companies, 83 nonmember trust companies that are subsidiaries of bank holding companies, and 13 entities which are branches or agencies of foreign banking organizations or edge corporation subsidiaries of domestic banking institutions.

On-site examinations are essential to ensure the safety and soundness of financial institutions that have fiduciary operations. These examinations include (1) an evaluation of management, policies, audit and control procedures, and risk management, (2) an assessment of the quality of trust assets, (3) an assessment of earnings, (4) a review for conflicts of interest, and (5) a review for compliance with laws, regulations, and general fiduciary principles. During 1996, Federal Reserve examiners conducted 206 on-site trust examinations of state member banks and trust companies, branches and agencies of foreign banking organizations or edge corporation subsidiaries of domestic banking institutions which held approximately $6.6 trillion in fiduciary assets.

### *Government Securities Dealers and Brokers*

The Federal Reserve is responsible for examining the government securities dealing and brokering of state member banks and foreign banks for compliance with the Government Securities Act of 1986 and regulations of the Department of Treasury. Forty-two state member banks and six state branches of foreign banks have notified the Board that they are currently government securities dealers or brokers that are not otherwise exempt from Treasury's regulations. During 1996 the Federal Reserve conducted examinations of broker–dealer activities in government securities at state member banks and foreign banks.

### *Municipal Securities Dealers and Clearing Agencies*

The Securities Act Amendments of 1975 made the Board responsible for supervising state member banks and bank holding companies that act as municipal securities dealers or as clearing agencies. The Board supervises thirty-eight banks that act as municipal securities dealers and three clearing agencies that act as custodians of securities involved in transactions settled by booking entries. In 1996 the Federal Reserve examined all three of the clearing agencies and 21 of the banks that deal in municipal securities.

### *Securities Subsidiaries of Bank Holding Companies*

Section 20 of the Banking Act of 1933 (the Glass–Steagall Act) prohibits the affiliation of a member bank with a company that is "engaged principally" in underwriting or dealing in securities. The Board in 1987 approved proposals by banking organizations to underwrite and deal on a limited basis in specified classes of bank "ineligible" securities (that is, commercial paper, municipal revenue bonds, conventional residential mortgage-related securities, and securitized consumer loans) in a manner consistent with section 20 of the Glass–Steagall Act and the Bank Holding Company Act. At that time, the Board limited revenues from these newly approved activities to no more than 5 percent of total revenues for each section 20 securities subsidiary. This limit was subsequently increased in September 1989 to 10 percent. In January 1993, the Board adopted an optional indexed revenue test that reflects the changes in the level and structure of interest rates since 1989.

In January 1989, the Board approved applications by bank holding companies to underwrite and deal in corporate and sovereign debt and equity securities, subject, in each case, to reviews of managerial and operational infrastructure and other conditions and requirements or firewalls, specified by the Board. In approving this broader range of activities, the Board also adopted more restrictive firewalls than those contained in its 1987 approval order.

Based on its experience supervising these section 20 subsidiaries and developments in the securities markets since the revenue test was adopted, the Board concluded in December 1996 that a section 20 firm could derive up to 25 percent of its revenue from underwriting and dealing in ineligible securities. In light of this action and an accounting change concerning the treatment of interest earned on securities that may be held by a member bank, the Board concurrently eliminated the optional indexed revenue test. Also, during 1996, the Board eased or eliminated three of the firewalls imposed on the operations of section 20 subsidiaries, and continued work on an extensive review of all other firewalls in order to eliminate unnecessary regulatory burden and enable section 20 subsidiaries to operate in an efficient, effective manner. This effort resulted in the publication for comment early in January 1997 of a proposal to eliminate most firewalls and to modify the remaining ones to ease compliance burdens. It was proposed that remaining firewalls be formally adopted as operating standards applicable to section 20 subsidiaries.

At year-end 1996 forty bank holding companies held section 20 subsidiaries authorized to underwrite and deal in ineligible securities. Of these, twenty-two could underwrite any debt or equity security; three could underwrite any debt security; and fifteen could underwrite only the limited types of debt securities approved by the Board in 1987. The Federal Reserve uses specialized procedures for reviewing operations of these securities subsidiaries; it conducted 40 such inspections in 1996.

### *Transfer Agents*

Federal Reserve examiners also conduct examinations of state member banks and bank holding companies that are registered transfer agents. Among other things, transfer agents counter-sign and monitor the issuance of securities, register their transfer, and exchange or convert such securities. During 1995, Federal Reserve examiners conducted on-site examinations at 77 of the 170 banks and bank holding companies registered as transfer agents with the Board.

### *Surveillance and Monitoring*

The Federal Reserve monitors the financial condition and performance of individual banking organizations and of the aggregate banking system as a whole to identify areas of supervisory concern. Reserve Banks and the Board use automated surveillance screening systems to identify organizations with poor or deteriorating financial profiles and to identify adverse trends affecting the banking system. Information from these surveillance activities is then used to intensify analysis and allocate additional examination resources to institutions vulnerable to deterioration.

An integral part of the bank surveillance function is an automated system which is used to estimate examination ratings for all banks and to identify banks with the potential to become critically undercapitalized over a two year horizon. In 1996, the Federal Reserve undertook a validation effort for this surveillance model.

The Federal Reserve also continued to implement revisions and additions to its bank holding company surveillance system to further assist supervisory staff in evaluating the financial profiles of individual bank holding companies. During 1996, quarterly screens evaluating capital markets activities and liquidity for consolidated bank holding companies were completed. These changes were augmented by the development of a set of ‘‘parent only’ screens which focus on the bank holding companies’ individual (nonconsolidated) operations.

Other efforts were undertaken during 1996 to support and enhance the effectiveness of Federal Reserve surveillance and monitoring activities. For example, the System introduced PRISM, Performance Report Information and Surveillance Monitoring. PRISM provides access to National Information Center (NIC) data on banks, bank holding companies, banking subsidiaries of bank holding companies, and Off-Site Risk Analysis (Surveillance). The Federal Reserve also implemented a new internal system to access Uniform Bank Performance Reports in March, 1996.

The Federal Reserve also completed a review of the definitions of commercial banks, savings bank, and bank holding companies used by various divisions of the Board, the Reserve Banks, and the FDIC. The result was standard definitions of these commonly selected institutional groupings to assist the Board and Reserve Banks in providing consistent figures to division management, the

Board, and the public. Automated monitoring systems continue to rely heavily on the information in the regulatory reports filed by banking organizations. To ensure the timeliness and accuracy of the reports, the Federal Reserve maintains the Regulatory Reports Monitoring System to track domestic and foreign banking organizations that file late or inaccurately.

The Federal Reserve actively participates with other federal and state banking authorities in efforts to enhance surveillance tools; currently, the Federal Reserve chairs the Federal Financial Institutions Examination Council Task Force on Surveillance.

## International Activities

The Federal Reserve plays a critical role in the supervision and regulation of the international activities of U.S. banking organizations and the U.S. activities of foreign banking organizations. The Board provides authorization and regulation of foreign branches of member banks; overseas investments by member banks, Edge Act corporations and agreement corporations, and bank holding companies; and investments by bank holding companies in export trading companies. The Board also charters Edge Act corporations. In addition, the Board acts on applications by foreign banking organizations to acquire U.S. banks; to establish U.S. branches, agencies, representative offices, and commercial lending company subsidiaries; and to engage in nonbanking activities in the United States.

### Foreign Office Operations of U.S. Banking Organizations

The Federal Reserve examines the international operations of state member banks, Edge Act corporations, and bank holding companies, principally at the U.S. head offices of these organizations, where the ultimate responsibility for their foreign offices lies. In 1996 the Federal Reserve conducted on-site full-scope and targeted-scope examinations of eleven foreign branches of state member banks and sixty-nine foreign subsidiaries of Edge Act corporations and bank holding companies. All of the examinations abroad were conducted with the cooperation of the supervisory authorities of the countries in which they took place; when appropriate, the examinations were coordinated with the Office of the Comptroller of the Currency. Also, examiners made forty-nine visitations to the overseas offices of U.S. banks to obtain financial and operating information, and in some instances, to evaluate their compliance with corrective measures or to test-check adherence to safe and sound banking practices.

#### *Foreign Branches of Member Banks*

Under provisions of the Federal Reserve Act and of the Board's Regulation K (International Banking Operations), member banks must obtain Board approval to establish branches in foreign countries. In reviewing proposed foreign branches, the Board considers the requirements of the law, the condition of the bank, and the bank's experience in international business. In 1996 the Federal Reserve approved the opening of 25 foreign branches of 15 banks. By the end of 1996, 96 member banks were operating 771 branches in foreign countries and overseas areas of the United States; 66 national banks were operating 586 of these branches, and 30 state member banks were operating the remaining 185 branches. In addition, 23 nonmember banks were operating 34 branches in foreign countries.

### *Edge Act and Agreement Corporations*

Edge Act corporations are international banking organizations chartered by the Board to provide all segments of the U.S. economy with a means of financing international business, especially exports. An agreement corporation is a state-chartered or federally chartered company that enters into an agreement with the Board not to exercise any power that is impermissible for an Edge Act corporation.

Under sections 25 and 25(A) of the Federal Reserve Act, Edge Act and agreement corporations may engage in international banking and foreign financial transactions. These corporations, which usually are subsidiaries of member banks, may (1) conduct a deposit and loan business in states other than that of the parent provided that the business is strictly related to international transactions and (2) make foreign investments that are broader than those of member banks because they can invest in foreign financial organizations, such as finance companies and leasing companies, as well as in foreign banks.

In 1996, the Federal Reserve approved one new Edge Act corporation and seven new agreement corporations. At year-end, seventy-three Edge Act and agreement corporations, with total parent-only assets of $40 billion at year-end, were operating with forty-two domestic branches. During the year, the Federal Reserve examined all seventy-three corporations.

### *Foreign Investments*

Under the Federal Reserve Act and the Bank Holding Company Act, U.S. banking organizations may engage in activities overseas with the authorization of the Board. Significant investments require advance review by the Board, although pursuant to Regulation K, most foreign investments may be made under general-consent procedures that involve only after-the-fact notification to the Board.

### *Export Trading Companies*

In 1982 the Bank Export Services Act amended section 4 of the Bank Holding Company Act to permit bank holding companies, their subsidiary Edge Act or agreement corporations, and bankers' banks to invest in export trading companies, subject to certain limitations and after Board review. The purpose of this amendment was to allow effective participation by bank holding companies in the financing and development of export trading companies. The Export Trading Company Act Amendments of 1988 provide additional flexibility for bank holding companies engaging in export trading activities. Since 1982 the Federal Reserve has acted affirmatively on notifications by forty-eight bank holding companies.

## U.S. Activities of Foreign Banks

The Federal Reserve has broad authority to supervise and regulate the U.S. activities of foreign banks that engage in banking and related activities in the United States through branches, agencies, representative offices, commercial lending companies, Edge Act corporations, banks, and certain nonbank companies. Foreign banks continue to be significant participants in the U.S. banking system. As of year-end 1996, 281 foreign banks from 60 countries operated 432 state-licensed branches and agencies (of which 25 are insured by the FDIC) as well as 66 branches and agencies licensed by the OCC (of which 6 have FDIC insurance). These foreign banks also directly owned 10 Edge Act corporations and 4 commercial lending companies. In addition, they held an equity interest of at least 25 percent in 90 U.S. commercial banks. Altogether, these U.S. offices of foreign banks control approximately 20 percent of U.S. banking assets. These foreign banks also operated 138 representative offices. An additional 115 foreign banks operated in the United States solely through a representative office.

The Federal Reserve has acted to ensure that all state-licensed and federally licensed branches and agencies receive an on-site examination at least once during each twelve-month period either by the Federal Reserve or by a state or other federal regulator. The Federal Reserve conducted or participated with state and federal regulatory authorities in 704 examinations during 1996. The Foreign Bank Supervision Enhancement Act of 1991 requires Federal Reserve approval of the establishment of branches, agencies, commercial lending company subsidiaries, and representative offices by foreign banks in the United States. In 1996, the Federal Reserve approved applications by 19 foreign banks from 12 foreign countries to establish branches, agencies, and representative offices.

### Joint Program for Supervising the U.S. Operations of Foreign Banking Organizations

In 1995 the Federal Reserve, in cooperation with the other federal and state banking supervisory agencies, formally adopted the joint program for supervising the U.S. operations of foreign banking organizations. The program has two major parts. The first focuses primarily on those FBOs that have multiple U.S. operations and is intended to better coordinate the efforts of the various U.S. supervisory agencies.

The second part of the program is a review of the financial and operational profile of each FBO to assess its general ability to support its U.S. operations and to determine what risks, if any, the FBO poses through its U.S. operations. Together, these two processes provide critical information to the U.S. supervisors in a logical, uniform, and timely manner. During 1996 the Federal Reserve continued to implement program goals through coordination with other supervisory agencies and the development of financial and risk assessments of foreign banking organizations and their U.S. operations.

### Technical Assistance

In 1996 the System provided staff for technical assistance missions and training sessions on bank supervisory matters to a number of central banks in countries of the former Soviet Union, Eastern Europe, Asia, the Caribbean, and Latin America.

## Supervisory Policy

The Federal Reserve amended its guidelines on risk-based capital by incorporating a measure for market risk. In addition, the Federal Reserve approved for public comment two proposals to amend the capital guidelines in other areas. The Federal Reserve made substantial progress in revising its examination and inspection processes to enhance its effectiveness and address changes in the banking industry, and improving supervisory reporting and disclosure by the banking industry. In concert with the other agencies, the Federal Reserve also issued a major revision to the Uniform Financial Institutions Rating System.

## Risk-Based Capital Standards

The risk-based capital requirements adopted by the Federal Reserve in 1989 remained in effect and were expanded in 1996. These requirements implement the international risk-based capital standards that were proposed by the Basle Committee on Banking Regulation and Supervisory Practices (Basle Supervisors' Committee) and endorsed by the Group of Ten (G-10) countries in July 1988..[3] The standards include a framework for calculating risk-adjusted assets and assigning assets to broad categories based primarily on credit risk. Banking organizations are expected to maintain capital equal to at least 8 percent of their risk-adjusted assets.

To supplement the risk-based capital standards, the Federal Reserve in 1990 also issued leverage guidelines setting forth minimum ratios of capital to total assets to be used in the assessment of an institution's capital adequacy.

### *Amendments*

During 1996 the Board adopted amendments to its risk-based capital guidelines in the following areas.

*Market risk.* On September 6, 1996, the Federal Reserve, together with the FDIC and OCC, issued a final rule that incorporated into the risk-based capital framework a capital charge for market risk associated with foreign exchange and commodity activities and with the trading of debt and equity instruments. Regulated institutions with significant market risk exposure must measure their market risk exposure using an internal risk measurement model subject to certain regulatory criteria and begin holding capital in support of their market risk by January 1, 1998. The final rule was based on a supplement to the Basle Accord that was issued January 1996.

*Interest rate risk.* On June 26, 1996, the Federal Reserve along with the FDIC and OCC issued a Joint Agency Policy Statement describing a common framework for the supervision of interest rate risk in banking institutions. This framework calls for a review of the qualitative characteristics and adequacy of an institution's interest rate risk management as well as an assessment of risk to its earnings and the economic value of its capital. The framework is consistent with 1995 revisions to risk-based capital regulations that incorporated the exposure of that economic value to changes in interest rates as an important element in the evaluation of capital adequacy.

The policy statement describes sound practices for managing interest rate risk, emphasizing the importance of adequate oversight by the board of directors and senior management and a comprehensive risk management process that identifies, measures, and controls interest rate risk. The agencies also indicated that they are no longer pursuing a standardized supervisory measure for interest rate risk, as had been proposed in 1995. In lieu of any standardized measure, the agencies will rely on surveillance screens and, during the examination process, the bank's own measurement system to evaluate the level of a bank's risk. Consistent with this framework, some modest revisions are being made to the Call Report in 1997 to enhance supervisory monitoring capabilities with respect to interest rate risk.

### *Proposed Rules*

During 1996, the Federal Reserve approved for public comment two proposals to amend its capital adequacy guidelines.

*Collateralized transactions.* On August 16, 1996, the Federal Reserve, together with the OCC, FDIC, and OTS, issued a proposal to amend the risk-based capital standards to make uniform the agencies' treatment for transactions secured by qualifying collateral. Under the proposal, regulated institutions would be allowed to hold less capital for certain transactions collateralized with a positive margin by cash or qualifying securities. The comment period for the proposal closed on October 15, 1996. A final amendment is expected in 1997.

*Technical modifications.* In November 1996 the Federal Reserve approved a proposal to amend its risk-based and leverage capital guidelines for state member banks in order to eliminate inconsistencies among the capital standards of the banking agencies. At the same time, the Federal Reserve approved a similar proposal for bank holding companies. The proposed amendments pertain to the risk-based capital treatment of presold one- to four-family residential properties, junior liens on one- to four-family residential properties, and investments in mutual funds. In addition, the proposals would simplify the leverage capital guidelines. The Federal Reserve expects that the proposals will be issued on a joint basis with the other agencies in early 1997.

## Risk Management Guidance

Throughout 1996 the Federal Reserve continued to focus on the adequacy of risk management practices and controls at banking organizations.

### *Risk-Focused Safety and Soundness Examinations and Inspections*

Over the last several years, a committee of senior staff from the Federal Reserve System has undertaken a review of the examination and inspection processes to identify near- and long-term opportunities for enhancing the effectiveness, efficiency, and responsiveness of the supervisory process and to address the changing and ever complex banking and financial environment. The committee made a number of recommendations, which the Federal Reserve has begun to implement in its efforts to provide a more risk-focused approach to the supervision of banking organizations.

On May 24, 1996, the Federal Reserve's Division of Banking Supervision and Regulation issued examiner guidance to explain the changes now being implemented in the examination and inspection process and to outline other areas where further changes will occur. In summary, the Federal Reserve has adopted a risk-focused approach to examinations that places greater reliance on effective planning, as well as on the tailoring of each examination to the size and activities of the subject bank or bank holding company. Under this approach, examiners place greater emphasis on evaluating the adequacy of an institution's management process for identifying, measuring, monitoring, and controlling risk. When this process is determined to be sound, the level of transaction testing conducted by examiners can be reduced, commensurate with the quality of management practices and the materiality of the activities being reviewed.

## Coordination with Other Supervisors

The Federal Reserve has also sought to increase coordination with other banking agencies and to improve supervision in an environment of interstate banking. As part of these efforts, the Federal Reserve in April 1996 approved two initiatives, the State/Federal Protocol and the Model Agreement, which address the supervision of state-chartered banks operating across state lines.

The protocol is a statement of principles by the Federal Reserve, the FDIC, and the Conference of State Bank Supervisors on behalf of the state banking departments. It provides that the appropriate federal regulator and home state supervisor will endeavor to coordinate the supervision of interstate banks, particularly those with assets of $1 billion or more, so as to reduce regulatory burden and minimize duplicative regulatory actions, while fostering the safe and sound operation of the banks.

The Model Agreement specifies the actions that the appropriate federal regulator and the home state supervisor would take to fulfill the goals of the protocol, that is, the seamless supervision and examination of interstate, state-chartered banks. Further, on November 14, 1996, the Federal Reserve along with the FDIC and all of the state banking departments signed a Nationwide State/Federal Supervisory Agreement, which was based on the April 1996 Model Agreement.

## Derivatives Disclosures

The Federal Reserve, the other federal banking regulators, and industry groups continued their efforts to improve the quality of bank disclosures of derivatives activities to make these activities more transparent to the public and regulatory authorities. In September 1996 the Division of Banking Supervision and Regulation published in the *Federal Reserve Bulletin* its second annual analysis of derivatives-related disclosures of the top ten U.S. banks that deal in derivatives. This analysis summarizes the accounting standards that influenced the 1995 disclosures in the annual reports of these banks; it also reviews the improvements since 1993 in qualitative and quantitative disclosures about the credit and market risks of derivatives and about the earnings effect of derivatives activities.

In November 1996 the Basle Committee on Banking Supervision and the International Organisation of Securities Commissions issued their second joint report on the public disclosure of trading and derivatives activities of banks and securities firms worldwide. Using an analytical framework developed by the Federal Reserve, the report surveys the trading and derivatives activities disclosed in the 1995 annual reports of a sample of the largest, internationally active banks and securities firms in the G-10 countries and notes improvements made since 1993.

## Retail Sales of Nondeposit Investment Products

On December 30, 1996, the Board the OCC, and the FDIC published a notice seeking comment on amendments to Regulation H and Regulation K that would establish professional qualification requirements for state member banks and for branches and agencies of foreign banks that engage in sales of certain securities to retail customers. The amendments are based on the professional qualification requirements for registered representatives of broker–dealers.

The proposed regulation would require that certain forms be filed with the Board, including registration information for a bank employee who solicits, recommends, purchases, or sells certain securities for retail customers. The regulation also would require such employees and their immediate supervisors to take one of two qualifying examinatons given by the securities industry as a precondition to selling. Continuing education requirements also would be imposed.

## National Information Center

The Division of Banking Supervision and Regulation has overall responsibility for the management of the National Information Center (NIC). NIC contains data bases that are maintained at the Board of Governors and made available to staff members at the Board, the Reserve banks, and other federal and state banking agencies. NIC comprises structure data for banks, nonbanks, and bank holding companies; international data for U.S. holding companies and foreign banking organizations with activities in the United States; financial information, such as Call Report data for banks and FR-Y report data for bank holding companies; and supervisory information based on inspections and examinations.

During 1996, software development continued to improve the usefulness of NIC through the use of distributed technologies. This effort, begun in 1995, is designed to exploit the Federal Reserve System's recently implemented intranet and the expanding use of client/server applications. Implementation of these improvements began in 1996 and will be accomplished through several phases through 1998. In addition, much progress was made in 1996 toward providing the public access to nonconfidential NIC information. In early 1997 a public Internet page will be available to provide access to banking structure information, balance sheets, and income statements.

To expand the use of NIC, training seminars were conducted for staff members throughout the System, and new applications were developed to make the vast amount of NIC data more easily accessible to the staff. In addition, efforts have been made to make NIC data and software available to state banking agencies for their use as a supervisory tool.

## Use of Automation

To increase efficiency in the examination of state member banks, the Federal Reserve has applied new technology to many routine aspects of an examiner's work. This effort has led to development of an automated system, referred to as the Examiner Workstation, that automates much of the quantitative analysis of banking organizations, including sampling and evaluation of loan and investment portfolios. Automation has also been applied to the planning and documentation of examinations. These changes should help examiners identify and evaluate risks more efficiently.

To assist in the supervision of U.S. branches and agencies of foreign banking organizations (FBOs), the Federal Reserve is developing an automated system, referred to as the FBO Desktop, that provides information for use in off-site reviews, including information on foreign financial systems, foreign accounting standards, and the financial performance of FBOs with U.S. operations. Supervisory staff throughout the System will be able to access this information electronically and will be able to review and comment on performance reports online.

## Staff Training

The Supervisory Education Program trains staff members having supervisory or regulatory responsibilities at the Reserve Banks, at the Board of Governors, and at state banking departments. Students from supervisory counterparts in foreign countries attend on a space-available basis. The program provides training at the basic, intermediate, and advanced levels for the four disciplines of bank supervision: bank examinations, bank holding company inspections, surveillance and monitoring activities, and applications analysis. Classes may be conducted in Washington, D.C., or at regional locations and may be held jointly with regulators of other financial institutions. The program is designed to increase the student's knowledge of the total supervisory and regulatory process and thereby provide a higher degree of cross training among staff members.

The System participates in training offered by the Federal Financial Institutions Examination Council (FFIEC) and, to a limited extent, in the training offered by certain other regulatory agencies. Activities include developing and implementing basic and advanced training in various emerging issues as well as in such specialized areas as trust activities, international banking, information systems, activities of municipal securities dealers, capital markets, payment systems risk, white collar crime, preparation and presentation of testimony, real estate lending, management, and instructor training. The System also

Number of Sessions of Training Programs for Banking Supervision and Regulation, 1996

| Program | Total | Regional |
|---|---|---|
| *Schools or seminars conducted by the Federal Reserve* | | |
| Core schools | | |
| Introduction to examinations | 10 | 6 |
| Financial institution analysis | 15 | 10 |
| Loan analysis | 8 | 5 |
| Bank management | 6 | 3 |
| Effective writing for banking supervision staff | 19 | 19 |
| Management skills | 22 | 19 |
| Conducting meetings with management | 19 | 19 |
| Other schools | | |
| Real estate lending seminar | 6 | 4 |
| Specialized lending seminar | 3 | ... |
| Senior forum for current banking and regulatory issues | 4 | 4 |
| Bank operations | 3 | 3 |
| Bank applications | 1 | ... |
| Bank holding company inspections | 8 | 6 |
| Basic entry-level trust | 1 | ... |
| Advanced trust | 1 | ... |
| Consumer compliance examination I | 3 | ... |
| Consumer compliance examination II | 5 | ... |
| Fair lending | 3 | ... |
| Information systems and emerging technology risk management | 3 | 3 |
| Information systems continuing education | 2 | ... |
| Intermediate information systems examination | 1 | ... |
| Capital markets seminars | 23 | 10 |
| Section 20 securities seminar | 4 | 3 |
| Internal controls | 3 | 3 |
| Seminar for senior supervisors of foreign central banks[1] | 2 | 1 |
| *Other agencies conducting courses*[2] | | |
| Federal Financial Institutions Examination Council | 68 | 11 |
| Office of the Comptroller of the Currency | 2 | ... |
| Federal Bureau of Investigation[3] | 1 | 1 |

NOTE. ... Not applicable.

1. Conducted jointly with the World Bank.

2. Open to Federal Reserve employees.

3. Co-sponsored by the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the Office of the Comptroller of the Currency, and the Resolution Trust Corporation.

co-hosts the World Bank Seminar for students from developing countries.

During 1996 the Federal Reserve conducted a variety of schools and seminars, and Federal Reserve staff members participated in several courses offered by or cosponsored with other agencies, as shown on the accompanying table.

In 1996 the Federal Reserve trained 3,730 students in System schools, 1,446 in schools sponsored by the FFIEC, and 124 in other schools, for a total of 5,300, including 242 representatives from foreign central banks. The number of student days of training was 27,169 in 1996; 27,856 in 1995; 25,036 in 1994; and 26,938 in 1993.

The Federal Reserve System also gave scholarship assistance to the states for training their examiners in Federal Reserve and FFIEC schools. Through this program 768 state examiners were trained: 407 in Federal Reserve courses, 352 in FFIEC programs, and 9 in other courses. During 1996 the Federal Reserve also continued its participation in joint core-supervision schools with the FDIC.

Every staff member seeking an examiner's commission is required to pass the Core Proficiency Examination, which includes a core content area and a specialty of the student's choice (Safety and Soundness, Consumer Affairs, Trust, or EDP). In 1996, 115 students took the examination.

## Federal Financial Institutions Examination Council

The FFIEC prescribes uniform federal principles and standards for the examination of depository institutions, promotes coordination of bank supervision among the federal banking agencies, and encourages better coordination of federal and state regulatory activities. During 1996, Federal Reserve staff members participated in the following FFIEC projects.

### Uniform Financial Institutions Rating System

On December 9, 1996, the FFIEC recommended that the Federal Reserve and the other banking agencies adopt revisions to update the Uniform Financial Institutions Rating System (UFIRS). UFIRS is an internal supervisory rating system used by the federal banking agencies to provide consistency among them in their evaluation of financial institutions and in their choice of institutions requiring special supervisory attention or concern. Adopted in November 1979, UFIRS is commonly referred to as the CAMEL rating system, with each of the letters of the word referring to one of the five rating components of the system. On December 19, 1996, the Federal Reserve adopted the revisions, which

Status of Students Registered for the Core Proficiency Examination, 1996

| Student status | Core | Specialty area | | | |
|---|---|---|---|---|---|
| | | Safety and soundness | Consumer | Trust | Electronic data processing |
| In queue, year-end 1995 | 24 | 20 | 3 | 0 | 1 |
| Registrants added | 124 | 106 | 14 | 4 | 0 |
| Test taken | 115 | 100 | 13 | 3 | 1 |
| Passed | 110 | 79 | 11 | 3 | 1 |
| Failed | 5 | 21 | 2 | 0 | 0 |
| In queue, year-end 1996 | 33 | 26 | 4 | 1 | 0 |

NOTE. Students choose a test in one specialty area to accompany the core examination.

are to be used in examinations beginning after January 1, 1997.

The revisions include the adoption of a sixth rating component, which covers a bank's sensitivity to market risks. With the addition of this component, the rating system will be referred to as CAMELS: (C) capital adequacy, (A) asset quality, (M) management, (E) earnings, (L) liquidity, and (S) sensitivity to market risks. The revised system highlights a bank's processes to identify, measure, monitor, and control risks in each of the component and composite ratings, particularly in the management component. At community banks, the sensitivity component will primarily be used to indicate the examiner's assessment of the exposure to, and management of, interest rate risk. At larger regional and money center banks, the component will also encompass price and foreign exchange risks when these risks are significant to the bank.

## Disclosure of the Components of the Supervisory Rating Systems

Acting upon a recommendation of the FFIEC, the Federal Reserve in November instructed Reserve Bank staff members to disclose to a bank's management and its directors, beginning January 1, 1997, the ratings given to the bank under the various supervisory rating systems. The Federal Reserve believes that such disclosure will better focus management attention on possible areas of weakness and the need for timely corrective action. The policy applies to the following rating systems: CAMELS for state member banks, BOPEC for bank holding companies, CAMEO for Edge and agreement corporations and overseas subsidiaries of U.S. banks, ROCA for U.S. branches and agencies of foreign banking organizations, the Uniform Interagency Trust Rating System, and the Uniform Interagency Rating System for Data Processing Operations.

## Revisions to the Call Report

In December the Federal Reserve and the other federal banking agencies announced revisions to the bank Reports of Condition and Income (Call Report) to adopt generally accepted accounting principles (GAAP) as the reporting basis in areas of the Call Reports where they were not already in effect, effective with the March 1997 report date. The change brings the accounting principles used for bank regulatory reports into conformity with the GAAP reporting basis used in bank holding company FR Y reports, savings association Thrift Financial Reports, and general-purpose financial statements. The change is also consistent with the objectives of section 307 of the Riegle Community Development and Regulatory Improvement Act of 1994, which requires the federal banking agencies to work jointly to develop a single form for the filing of core information by banks, savings associations, and bank holding companies.

During 1996, the FFIEC also implemented several improvements to the Call Report to focus on bank liquidity ratios and certain capital and asset amounts used in the calculation of regulatory capital ratios. The improvements, effective with the March 1996 report, provide the agencies with better data on short-term liabilities and assets for liquidity purposes and information necessary for the supervision of bank activities in other areas.

The FFIEC issued three substantially revised report forms that improve the ability of the banking agencies to monitor compliance with regulations that impose restrictions on the extension of bank loans to certain insiders of another bank and to provide better information on the risk exposure to U.S. banks from international lending. The FFIEC also announced revisions to the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks to adopt GAAP and certain other disclosures to maintain consistency with the bank Call Report.

In December the FFIEC announced that approximately thirty items deemed unnecessary will be deleted from the Call Report, effective with the March 1997 reporting date. Also in the announcement were new items to be added to the Call Report; among them are items related to the adoption of GAAP, the potential level of bank exposures to interest rate risk, and the need for better data on bank involvement in credit derivatives.

### *Mortgage Servicing Rights*

In June, the Financial Accounting Standards Board issued Statement No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," thereby revising the accounting and reporting standards for all servicing assets, including mortgage servicing rights and related assets. In response to this statement, the FFIEC in December issued interim guidance on reporting and capital treatment for servicing rights. The agencies are expected to issue, in 1997, a proposed amendment to their capital adequacy rules with regard to the treatment of servicing rights and related assets.

### *Review of Regulations and Policies*

In accordance with section 303(a)(2) of the Riegle Community Development and Regulatory Improvement Act of 1994, the federal banking agencies reviewed their implementations of their common statutory and supervisory policies. Under the auspices of the FFIEC, staff members of the agencies formed sixty-five interagency working groups to eliminate inconsistencies and outmoded and duplicative requirements. The agencies submitted a joint report to the Congress on September 23, 1996, that covered this work as well as the results of the agencies' own internal reviews of their regulations and policies to address the streamlining requirements of section 303(a)(1) (for further details, see chapter on Regulatory Simplification).

### *Appraisal Subcommittee*

The FFIEC Appraisal Subcommittee was established under title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, in part to monitor the states' programs for the licensing and certification of appraiser for compliance with the statute. The subcommittee is made up of one staff member from each of the FFIEC agencies and the Department of Housing and Urban Development.

Section 315 of the Riegle Community Development and Regulatory Improvement Act of 1994 directed the subcommittee to encourage states to develop reciprocity agreements with each other. The agreements would allow appraisers licensed or certified in one state to perform appraisals in other states and would determine appropriate fees and requirements for temporary practice provisions established by states for appraisers. On October 21, the subcommittee issued a proposed policy statement with guidelines on temporary practice and reciprocity, and it expects to take action on the proposal in early 1997.

## Regulation of the U.S. Banking Structure

The Board administers the Bank Holding Company Act, the Bank Merger Act, and the Change in Bank Control Act for bank holding companies and state member banks. In doing so, the Federal Reserve acts on a variety of proposals that directly or indirectly affect the structure of U.S. banking at the local, regional, and national levels. The Board also has primary responsibility for regulating the international operations of domestic banking organizations and the overall U.S. banking operations of foreign banks, whether conducted directly through a branch or agency or indirectly through a banking or commercial lending subsidiary (treated above in the section on International Activities).

### Bank Holding Company Act

By law, a company must obtain the Federal Reserve's approval if it is to form a bank holding company by acquiring control of one or more banks. Once formed, a bank holding company must receive the Federal Reserve's approval before acquiring additional banks or nonbanking companies. The Bank Holding Company Act was amended in 1996 to permit bank holding companies that are well run and satisfy specific criteria to commence certain nonbanking activities on a de novo basis without prior approval from the Board, and to establish an expedited prior-notice procedure for other activities and for small acquisitions.

In reviewing an application or notice filed by a bank holding company for prior Board approval, the Federal Reserve considers factors including the financial and managerial resources of the applicant, the future prospects of both the applicant and the firm to be acquired, the convenience and needs of the community to be served, and the potential public benefits and competitive effects of the proposal. In 1996 the Federal Reserve acted on 1,528 bank holding company and related applications or notices. The Federal Reserve approved 336 proposals to organize bank holding companies; approved 119 proposals to merge existing bank holding companies; approved 331 proposals by existing bank holding companies to acquire or retain banks; approved 536 and denied 2 requests by existing companies to acquire nonbank firms engaged in activities closely related to banking; and approved 204 other applications. Data on these and related bank holding company decisions are shown in the accompanying table.

### Bank Merger Act

The Bank Merger Act requires that all proposed mergers of insured depository institutions be acted upon by the appropriate federal banking agency. If the institution surviving the merger is a state member bank, the Federal Reserve has primary jurisdiction. During 1996, the Federal Reserve approved 133 merger applications. As required by law, each merger is described in this REPORT (in table 16 of the Statistical Tables chapter).

When the FDIC, the OCC, or the OTS has jurisdiction over a merger, the Federal Reserve is asked to comment on the competitive factors to assure comparable enforcement of the antitrust provisions of the act. The Federal Reserve and those agencies have adopted standard terminology for assessing competitive factors in merger cases to assure consistency in administering the act. The Federal Reserve submitted 842 reports on competitive factors to the other federal banking agencies in 1996.

## Change In Bank Control Act

The Change in Bank Control Act requires persons seeking control of a bank or bank holding company to obtain approval from the appropriate federal banking agency before the transaction occurs. Under the act, the Federal Reserve is responsible for reviewing changes in the control of state member banks and of bank holding companies. In so doing, the Federal Reserve must review the financial position, competence, experience, and integrity of the acquiring person; consider the effect on the financial condition of the bank or bank holding company to be acquired; and determine the effect on competition in any relevant market.

The appropriate federal banking agencies are required to publish notice of each proposed change in control and to invite public comment, particularly from persons located in the markets served by the institution to be acquired. The federal banking agencies are also required to assess the qualifications of each person seeking control. During 1996 the Federal Reserve worked with the FDIC, the OCC, and the OTS to develop more uniform and streamlined procedures for implementing the Change in Bank Control Act. As discussed further below, many of the proposed revisions became part of a broader effort by the Board to improve and revise Regulation Y. In 1996, the Federal Reserve acted on 162 proposed changes in control of state member banks and bank holding companies.

## Public Notice of Federal Reserve Decisions

Each decision by the Federal Reserve that involves a bank holding company, bank merger, or a change in control, is effected by an order or announcement. Orders state the decision along with the essential facts of the application or notice, and the basis for the decision; announcements state only the decision. All orders and announcements are released immediately to the public; they are subsequently reported in the Board's weekly H.2 statistical release and in the monthly *Federal Reserve Bulletin.*

### Bank Holding Company Decisions by the Federal Reserve, Domestic Applications, 1996

| Proposal | Direct action by the Board of Governors | | Action under authority delegated by the Board of Governors | | | | | Total |
|---|---|---|---|---|---|---|---|---|
| | | | Director of the Division of Banking Supervision and Regulation | | Office of the Secretary | Federal Reserve Banks | | |
| | Approved | Denied | Approved | Denied | Approved | Approved | Permitted | |
| Formation of holding company | 15 | 0 | 0 | 0 | 3 | 254 | 64 | 336 |
| Merger of holding company | 18 | 0 | 0 | 0 | 12 | 89 | 0 | 119 |
| Retention of bank | 2 | 0 | 0 | 0 | 0 | 0 | 0 | 2 |
| Acquisition | | | | | | | | |
| Bank | 49 | 0 | 0 | 0 | 9 | 271 | 0 | 329 |
| Nonbank | 147 | 2 | 0 | 0 | 29 | 0 | 360 | 538 |
| Bank service corporation | 0 | 0 | 0 | 0 | 7 | 54 | 37 | 98 |
| Other | 15 | 0 | 47 | 0 | 0 | 44 | 0 | 106 |
| **Total** | **246** | **2** | **47** | **0** | **60** | **712** | **461** | **1,528** |

The H.2 release also contains announcements of applications and notices received by the Federal Reserve but not yet acted on.

## Timely Processing of Applications

The Federal Reserve maintains target dates and procedures for the processing of applications. These target dates promote efficiency at the Board and the Reserve Banks and reduce the burden on applicants. The time allowed for a decision ranges from thirty to sixty days, depending on the type of application or notice. During 1996, 96 percent of the decisions met this standard.

## Delegation of Applications

Historically, the Board has delegated certain regulatory functions—including the authority to approve, but not to deny, certain types of applications—to the Reserve Banks, to the director of the Board's Division of Banking Supervision and Regulation and to the Secretary of the Board. The delegation of responsibility for applications permits staff members at both the Board and the Reserve Banks to work more efficiently by removing routine cases from the Board's agenda. In 1996, 80 percent of the applications processed were acted on under delegated authority.

## Banking and Nonbanking Proposals

During 1996, the Board approved several merger proposals involving some of the largest banking organizations in the United States, including a proposal to form the largest bank holding company. As with similar prior cases, these proposals generated many comments from the public, particularly with respect to Community Reinvestment Act, fair lending, and competitive issues.

In December of 1996, the Board granted Federal Reserve membership to a newly-formed state chartered uninsured trust company that proposed to act as a clearinghouse for the multilateral netting of foreign exchange transactions. The clearinghouse was intended to be a mechanism for reducing settlement risk in the global foreign exchange market. At the same time, the Board approved the related notices of eight U.S. and Canadian banking organizations to invest in the uninsured trust company.

During the year, the Board continued to act on proposals involving the establishment and/or expansion of a section 20 subsidiary by a bank holding company. In connection with one of those proposals, the Board significantly reduced the operating restrictions applicable to "riskless principal" activities. In subsequent months, the Board took several more actions to reduce further the operating restrictions, or "firewalls," related to section 20 activities, and raised the limit on a section 20 company's "ineligible revenue" from 10 percent to 25 percent. In connection with one of the section 20 proposals, the Board also permitted a bank holding company to act as a primary clearing firm for professional floor traders trading for their own accounts on two U.S. futures exchanges. The Board had previously denied this activity for the same bank holding company in 1991.

In the course of acting on various other nonbanking proposals filed by foreign and domestic bank holding companies, the Board expanded the scope of permissible data processing activities to facilitate electronic banking and permitted one bank holding company to maintain stronger relationships with mutual funds for which it planned to provide investment advisory and administrative services.

### Applications by State Member Banks

State member banks must obtain the permission of the Federal Reserve to open new domestic branches, to make investments in bank premises that exceed 100 percent of capital stock, and to add to their capital bases from sales of subordinated debt. State member banks must also give six months' notice of their intention to withdraw from membership in the Federal Reserve, although the notice period may be shortened or eliminated in specific cases.

### Stock Repurchases by Bank Holding Companies

A bank holding company sometimes purchases its own shares from its shareholders. When the company borrows the money to buy the shares, the transaction increases the debt of the bank holding company and simultaneously decreases its equity. Relatively larger purchases may undermine the financial condition of a bank holding company and its bank subsidiaries. The Federal Reserve may object to stock repurchases by holding companies that fail to meet certain standards, including the Board's capital guidelines. In 1996 the Federal Reserve reviewed fifty-four proposed stock repurchases by bank holding companies, all of which were acted upon under delegated authority either by the Reserve Banks or by the Secretary of the Board.

## Enforcement of Other Laws and Regulations

The Board is also responsible for the enforcement of various laws, rules and regulations other than those specifically related to bank safety and soundness and the integrity of the banking structure.

### Financial Disclosure by State Member Banks

State member banks must disclose certain information of interest to investors if they issue securities registered under the Securities Exchange Act of 1934. This information includes financial reports and proxy statements. By statute, the Federal Reserve's financial disclosure rules must be substantially similar to those issued by the Securities and Exchange Commission (SEC). At the end of 1996, thirty-six state member banks, most of which are small or medium-sized institutions, were registered with the Federal Reserve under the Securities Exchange Act.

### Bank Secrecy Act

The Currency and Foreign Transactions Reporting Act (the Bank Secrecy Act) was originally designed as a means to create and maintain records of various financial transactions that otherwise would not be identifiable in an effort to trace the proceeds of illegal activities. In recent years, the Bank Secrecy Act has been regarded as a primary tool in the fight against money laundering. The records required to be reported and maintained by financial institutions under the Bank Secrecy Act provide law enforcement authorities with data useful in the detection and prevention of unlawful activity. The Federal Reserve, through its examination process and other off-sight measures, monitors compliance with the requirements of the Bank Secrecy Act by the institutions it supervises.

In 1996 the Federal Reserve issued new procedures for the banking community to use in reporting suspicious activities related to money laundering and other financial crimes. The procedures are designed to lessen the reporting burden on financial institutions and to make the reports more useful in the investigation of money laundering and other banking crimes. The Federal Reserve acted as the lead regulatory agency in the development of the new procedures.

The Federal Reserve also used new interagency anti-money-laundering examination procedures as required by section 404 of the Riegle Community Development and Regulatory Improvement Act of 1994. The Federal Reserve acted as the lead regulatory agency in the development and subsequent revision of the interagency examination procedures.

The Federal Reserve, through its appointed senior staff representative, continued to provide expertise and guidance to the Bank Secrecy Act Advisory Council, a committee created by Congressional mandate to propose additional anti-money laundering measures to be taken under the Bank Secrecy Act. Also, through the Special Investigations and Examinations Section, the Federal Reserve has assisted in the investigation of money laundering activities and provided anti-money laundering training to designated staff members at each Reserve Bank.

The Federal Reserve has also participated extensively in the Financial Action Task Force, which in 1996 provided anti-money-laundering training to numerous foreign governments and central banking authorities. In addition, a representative of the Federal Reserve participated in the Financial Action Task Force review of the progress made in adopting and implementing anti-money-laundering measures by certain foreign governments.

## Securities Regulation

Under the Securities Exchange Act of 1934, the Board is responsible for regulating credit in certain transactions involving the purchase or carrying of securities. The Board limits the amount of credit that may be provided by securities brokers and dealers (Regulation T), by banks (Regulation U), and by other lenders (Regulation G). Regulation X applies these credit limitations, or margin requirements, to certain borrowers and to certain credit extensions, such as credit obtained from foreign lenders by U.S. citizens.

Several regulatory agencies enforce compliance with the Board's securities credit regulations. The SEC, the National Association of Securities Dealers, and the national securities exchanges examine brokers and dealers for compliance with Regulation T. The federal banking agencies examine banks under their respective jurisdictions for compliance with Regulation U. The compliance of other lenders with Regulation G is examined by the Board, the Farm Credit Administration, the National Credit Union Administration, or the OTS, according to the jurisdiction involved. At the end of 1996, 774 lenders were registered under Regulation G, and 503 came under the Board's supervision. Of these 503, the Federal Reserve regularly inspects 249 either biennially or triennially, according to the type of credit they extend. An additional 254 lenders are exempted from periodic on-site inspections by the Federal Reserve but are monitored through the filing of periodic regulatory reports. During 1996, Federal Reserve examiners inspected 148 lenders for compliance with Regulation G.

In general, Regulations G and U impose credit limits on loans secured by publicly held equity securities when the purpose of the loan is to purchase or carry those or other publicly held equity securities. Regulation T limits the amount of credit that brokers and dealers may extend when the credit is used to purchase or carry publicly held debt or equity securities. Collateral for such loans at brokers and dealers must be securities in one of the following categories: those traded on national securities exchanges, certain over-the-counter (OTC) and foreign stocks that the Board designates as having characteristics similar to those of stocks listed on the national exchanges, bonds that meet certain requirements, or mutual funds regulated by the SEC.

The Federal Reserve monitors the market activity of all OTC stocks to determine which of them are subject to the Board's margin regulations. The Board publishes the resulting List of Marginable OTC Stocks quarterly. In 1996, the OTC list was revised in February, May, August, and November. The November OTC list contained 4,718 stocks.

Pursuant to a 1990 amendment to Regulation T, the Board publishes a list of foreign stocks that are eligible for margin treatment at broker–dealers on the same basis as domestic margin securities. In 1996, the foreign list was revised in February, May, August, and November. The November foreign list contained 1,965 foreign stocks.

In April the Board adopted a revised version of Regulation T. The amendments are part of the Board's periodic review of its regulations and reflect consideration of the comments submitted in response to proposed amendments published in 1995. The final rule eliminates restrictions on the ability of broker–dealers to arrange for credit; increases the type and number of domestic and foreign securities that may be bought on margin and increases the loan value of some securities that are already marginable; deletes Board rules regarding options transactions in favor of the rules of the options exchanges; and reduces restrictions on transactions involving foreign persons, foreign securities, and foreign currency.

At the same time, the Board proposed further amendments to Regulation T, G, and U. The proposed amendments would allow broker–dealers to extend good faith credit on any non-equity security rather than only those currently permitted in the Board's rules; allow transactions involving non-equity securities to be effected in an account not subject to the restrictions of the Regulation T's margin account; remove restrictions on the ability of broker–dealers to calculate required margin for non-equity securities; and modify the method for determining which equity securities are subject to the Board's margin requirements under Regulations G, T and U.

Loans by State Member Banks to their Executive Officers, 1995–96

| Period | Number | Amount (dollars) | Range of interest rates charged (percent) |
|---|---|---|---|
| *1995* | | | |
| October 1–December 31 | 726 | 31,421,000 | 4.0–19.5 |
| *1996* | | | |
| January 1–March 31 | 717 | 34,334,000 | 3.0–18.0 |
| April 1–June 30 | 762 | 31,960,000 | 5.0–21.0 |
| July 1–September 30 | 756 | 37,498,000 | 4.5–18.0 |

SOURCE. Call Report.

Under section 8(a) of the Securities Exchange Act, a nonmember domestic or foreign bank may lend to brokers or dealers posting registered securities as collateral only if the bank has filed an agreement with the Board that it will comply with all the statutes, rules, and regulations applicable to member banks regarding credit on securities. The Board processed no new agreements from January to October 1996. In October 1996 the Congress enacted the National Securities Markets Improvement Act of 1996, which repealed section 8(a) of the Securities Exchange Act and limited the Board's authority under section 7 of the Securities Exchange Act to impose margin requirements on borrowings by certain broker–dealers.

In November the Board published an interpretation of Regulations G, T, and U in light of the enactment of the National Securities Markets Improvement Act of 1996. The interpretation reflects the statutory repeal of section 8(a) of the Securities Exchange Act and makes clear that the Board has not made a finding that it is necessary or appropriate either in the public interest or for the protection of investors to impose rules on borrowings by broker–dealers otherwise exempt under the new legislation. At the same time, the Board published proposed amendments to Regulations G, T, and U to implement the new legislation and further the policies behind its adoption.

In 1996, the Securities Regulation Section of the Board's Division of Banking Supervision and Regulation issued thirty interpretations of the margin regulations. Those that presented sufficiently important or novel issues were published in the Securities Credit Transactions Handbook, which is part of the Federal Reserve Regulatory Service. These interpretations serve as a guide to the margin regulations.

## Loans To Executive Officers

Under Section 22(g) of the Federal Reserve Act, state member banks must include in each quarterly Call Report all extensions of credit made by the bank to its executive officers since the date of the bank's previous report. The accompanying table summarizes this information.

## Federal Reserve Membership

At the end of 1996, 3,701 banks were members of the Federal Reserve System. Member banks operated 40,963 branches on December 31, 1996, and accounted for 39 percent of all commercial banks in the United States and for 69 percent of all commercial banking offices. ■