

---

## *Banking Supervision and Regulation*

The condition of the U.S. banking system remained robust during 1997: The industry reported further gains in asset quality, continued record earnings, and the highest equity-to-asset ratios in more than fifty years. Only one (small) insured commercial bank failed, and the assets of problem banks, at \$3.5 billion, continued to decline from already low levels. As a result, the U.S. banking industry appears to be among the strongest and most innovative of the major industrial countries and well positioned to meet the nation's financial needs.

This dramatic progress from the industry's stressed condition at the beginning of the decade is evidence of the underlying strength and resilience of the U.S. banking system and its ability to adapt to and, to a large extent, direct evolving practices in world financial markets. These practices, the expanded application of technology in the design and management of financial products, and the structural changes that are occurring within the U.S. and world financial systems present challenges and opportunities not only to many U.S. banks but also to the Federal Reserve in its role as a financial supervisor and regulator.

Changes in the nature and pace of bank activities have been most significant among the largest banking organizations, for which the growth of trading and derivatives activities has been profound. These events and the growing complexity of many activities have required that the Federal Reserve, in its supervisory role, place more emphasis on the management and internal control process within banks and less emphasis on independent transaction-testing. That

requirement, in turn, has fueled a need for more prior planning for examinations, increased training of examiners, and additional guidance on sound practices for both bankers and bank examiners. It has also made it necessary for the Federal Reserve to improve its own information systems, to allocate resources more productively, and to make better use of available technology in all aspects of its supervisory process.

In recent years the Federal Reserve has used the opportunity presented by the relatively trouble free domestic banking system to develop and promote sound risk-management practices throughout the industry, both domestically and abroad; to develop more efficient techniques for supervision; and, when prudent, to reduce the level of regulatory intrusion into the activities of U.S. banks and bank holding companies. Such efforts account for many of the Board's accomplishments in bank supervision and regulation during 1997. These accomplishments include support of international efforts to strengthen and coordinate the supervision of internationally active banks; reduction of regulatory restrictions on the activities of section 20 affiliates of bank holding companies; streamlining of the application process for many banks and bank holding companies; significant advances in the use of automation during bank examinations; and many other initiatives, discussed below.

More recently, in response to potential industry exposure associated with the century date change, the Federal Reserve has initiated an extensive supervision program that has included the issuance of several policy statements,

the conduct of comprehensive examinations, and an outreach program. Working closely with other federal and state banking regulators, the Federal Reserve has been focusing significant attention on banking industry preparedness regarding automated systems and their ability to calculate date-dependent information after the century date change. The outreach program has included numerous public statements and conferences intended to provide guidance to the industry on this significant matter. Further, the Federal Reserve is examining all banks subject to its supervision authority by June 30, 1998, for year 2000 readiness.

Adverse economic developments in Asian countries during the year directed attention to bank exposures in that part of the world as well as to emerging markets more generally. Consistent with the System's risk-focused approach for supervising large, internationally active banking organizations, the Federal Reserve's supervisory process during 1997 placed emphasis on evaluating the impact of these developments on U.S. banks that are active in the Asian markets, and on the U.S. operations of banks that are based there. In this connection, it is noteworthy that U.S. banking organizations continue to report historically high levels of capital and reserves.

### **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.<sup>1</sup> 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, 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.<sup>2</sup>

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 banks, the Change in Bank Control Act for bank holding companies and state member banks, and the International Banking Act. Also, the Federal Reserve is responsible for imposing margin requirements on securities transactions.

---

1. 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 laws. 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.

2. 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.

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. Many elements reviewed at bank holding companies and their nonbank subsidiaries differ from bank examinations; therefore, 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 an 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, including an assessment of internal policies, procedures, controls, and operations, (4) an assessment of the key financial factors of capital, earnings, liquidity, and sensitivity to market risk, and (5) a review for compliance with applicable laws and regulations.

#### *State Member Banks*

At the end of 1997, 992 state-chartered banks (excluding nondepository trust companies and private banks) were members of the Federal Reserve System. These banks represented about 10.9 percent of all insured U.S. commercial banks and held about 25 percent of all insured commercial bank assets in the United States.

The guidelines for Federal Reserve examinations of state member banks 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 most of these depository institutions; certain well-capitalized and well-managed institutions with assets of less than \$250 million may be examined every eighteen months.

During 1997, the Federal Reserve Banks conducted 552 examinations of state member banks (some of them jointly with the state agencies), and state banking departments conducted 346 independent examinations of state member banks.

#### *Bank Holding Companies*

At year-end 1997, the number of U.S. bank holding companies totaled 6,102. These organizations controlled about 7,015 insured commercial banks and held approximately 93.8 percent of all insured commercial bank assets.

Federal Reserve guidelines call for annual inspections of large bank holding companies and smaller companies that have significant nonbank assets. Certain small, noncomplex companies—

those that have less than \$1 billion in consolidated assets, do not have debt outstanding to the public, and do not engage in significant nonbank activities—are subject to a special supervisory program that became effective in 1997. The program permits a more flexible approach to supervising those entities in a risk-focused environment and is designed to improve the overall effectiveness and efficiency of the Federal Reserve's bank supervisory efforts. Each such holding company is subject to off-site review once during each supervisory cycle, which corresponds to the mandated examination cycle for the company's lead bank.

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 1997, the Federal Reserve inspected 1,682 bank holding companies. Altogether, Federal Reserve examiners conducted 1,782 bank holding company inspections, 137 of which were conducted off-site, and state examiners conducted 98 independent inspections.

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

In 1997, the Federal Reserve Banks recommended, and members of the Board's staff initiated and worked on, 105 enforcement cases involving 207 separate actions, such as cease and desist orders, written agreements, removal and prohibition orders, and civil money pen-

alties. Of these, 35 cases involving 67 actions were completed by year-end.

Of particular note was an action taken by the Board of Governors with regard to the illegal activities of the Bank of Credit and Commerce International (BCCI). After a factual hearing before an administrative law judge, the Board of Governors assessed a civil money penalty of \$37 million against Ghaiht R. Pharaon for his participation in BCCI's illegal acquisition of the failed Independence Bank of Encino, California.

In other significant matters, the Board of Governors assessed civil money penalties totaling \$30 million, including a fine of \$5 million, along with an order to disgorge profit of \$17.32 million, against a foreign bank for allegedly failing to file complete and accurate applications and reports in connection with its purchase and ownership of a U.S. bank; a fine of \$5 million against a foreign bank and its U.S. branch for misconduct related to the alleged misuse of confidential supervisory information, the making of allegedly false statements to bank supervisory officials, and the alleged obstruction of a formal investigation by bank supervisory officials; and a fine of \$2.5 million against a foreign bank and its U.S. branch for allegedly engaging in unsafe and unsound practices and violations of laws and regulations.

All final enforcement orders issued by the Board of Governors and all written agreements executed by the Federal Reserve Banks in 1997 are available to the public. In 1997, they became available on the Board's public Web site.

In addition to formal enforcement actions, the Federal Reserve Banks in 1997 completed 83 informal enforcement actions, such as memorandums of understanding and resolutions from boards of directors.

## Specialized Examinations

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

### *Information Technology*

Under the Interagency EDP Examination Program, the Federal Reserve examines the information technology activities of state member banks, U.S. branches and agencies of foreign banks, Edge Act and agreement corporations, and independent data centers that provide electronic data processing services to these institutions. On-site examinations are essential to ensure the safe and sound operation of financial institutions, at which computer operations may pose significant exposures. During 1997, the Federal Reserve conducted 420 examinations that focused on the safety and soundness of information technology and electronic data processing systems. The Federal Reserve was also the lead agency on 3 examinations of large, multiregional data processing servicers examined in cooperation with the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). In addition, Federal Reserve examiners initiated targeted reviews of banking organizations to assess their progress in preparing for the century date change.

### *Fiduciary Activities*

The Federal Reserve has supervisory responsibility for institutions that together hold more than \$9.2 trillion of discretionary and nondiscretionary assets in various fiduciary capacities. This group of institutions comprises 297 state-chartered member banks and trust companies, 86 nonmember trust companies that are subsidiaries of bank holding companies, and 17 entities that are either 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 1997, Federal Reserve examiners conducted 255 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.

### *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 with Department of the Treasury regulations. Thirty-eight state member banks and nine state branches of foreign banks have notified the Board

that they are government securities dealers or brokers not exempt from Treasury's regulations. During 1997, the Federal Reserve conducted 21 examinations of broker-dealer activities in government securities at state member banks and foreign banks.

#### *Municipal Securities Dealers and Clearing Agencies*

Under the Securities Act Amendments of 1975, the Board of Governors is responsible for the supervision of state member banks and bank holding companies that act as municipal securities dealers or as clearing agencies. The Board supervises thirty-seven banks that act as municipal securities dealers and three clearing agencies that act as custodians of securities involved in transactions settled by booking entry. In 1997, the Federal Reserve examined all three clearing agencies and twenty of the banks that act as municipal securities dealers.

#### *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 of Governors 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. In September 1989 the limit was increased to 10 percent.

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 firewalls more restrictive than those contained in its 1987 approval order.

Significant changes concerning the revenue limit and firewalls governing the activities of section 20 subsidiaries were implemented in 1997. On the basis of its experience supervising these section 20 subsidiaries as well as developments in the securities markets since the revenue test was adopted, the Board permitted, effective March 1997, section 20 firms to derive up to 25 percent of total revenues from underwriting and dealing in ineligible securities. In August 1997, the Board completed a review of firewalls, as required by the Riegle Community Development and Regulatory Improvement Act of 1994, for the purpose of eliminating unnecessary regulatory burden and enabling section 20 subsidiaries to operate in an efficient, effective manner. As a result of its review, the Board eliminated certain restrictions that have proved to be unduly burdensome or unnecessary in light of other laws and regulations. The remaining restrictions have been consolidated into a series of operating standards that are fully consistent with safe and sound operations.

At year-end 1997, forty-five bank holding companies held section 20 subsidiaries authorized to underwrite and deal in ineligible securities. Of these, twenty-eight could underwrite any debt

or equity security, two 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 follows specialized inspection procedures to review the operations of these securities subsidiaries; it conducted forty-one such inspections in 1997.

### *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 countersign and monitor the issuance of securities, register the transfer of securities, and exchange or convert securities. During 1997, Federal Reserve examiners conducted on-site examinations at 59 of the 160 banks and bank holding companies registered as transfer agents with the Board.

### Surveillance and Risk Assessment

The Federal Reserve monitors the financial condition and performance of individual banking organizations and of the banking system as a whole to identify areas of supervisory concern. The monitoring is accomplished, in part, through the use of automated screening systems. Surveillance screens address a number of aspects of banking performance, including capitalization, asset growth, loan quality, loan concentrations, liquidity, and capital markets activities. Information from these screens assists in allocating examination resources to institutions experiencing, or vulnerable to, deterioration and is also used in the examination-planning process. Among the automated screening systems used to monitor bank performance are two econometric models that use quarterly

Call Report data to estimate an examination rating for each bank and to identify banks having the potential to become critically undercapitalized over the subsequent two years.

During 1997, the Federal Reserve continued to refine its Systemwide surveillance programs, implementing parent-company-only screens that address bank holding company performance on an unconsolidated basis and adding nonbank screens to monitor the effect of nonbank activities on the strength of parent bank holding companies. In addition, changes were made to the capital markets monitoring screens to address credit derivatives activities and the adoption of the market risk capital rule. Development of a surveillance program for small shell bank holding companies was also begun, to assist with implementation of the Risk-Focused Supervision Policy for Small Shell Bank Holding Companies adopted by the Board in November.

To assist supervisory staff in evaluating individual bank holding companies, the Federal Reserve produces quarterly Bank Holding Company Performance Reports (BHCPRs), which provide detailed financial information on the condition and performance of individual bank holding companies. During the year, information on derivatives activities contained in BHCPRs was significantly revised to provide more data on the use of derivative instruments. The Federal Reserve also produces several statistical and analytical reports on the structure and condition of the banking industry for use in supervising banks and bank holding companies. During 1997, development of an Aggregate Loan Quality Analysis Report was completed. This report supplements loan concentration surveillance screens by providing additional detail on the quality of assets at institutions reporting con-

centrations in loans of various types. In addition, electronic access to National Information Center (NIC) data on banks, bank holding companies, and surveillance screen results is provided to supervisory staff through the Performance Report Information and Surveillance Monitoring system (PRISM).

The Federal Reserve actively works with the other federal banking authorities to enhance surveillance tools through its representation on the Federal Financial Institutions Examination Council Task Force on Surveillance Systems.

### **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. It supervises 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 Federal Reserve also supervises the U.S. activities of foreign banking organizations, including U.S. branches, agencies, and representative offices, U.S. bank subsidiaries, and commercial lending company subsidiaries and nonbanking subsidiaries.

#### **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 1997 the

Federal Reserve conducted examinations of 12 foreign branches of state member banks and 114 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 eight visits 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 their adherence to safe and sound banking practices.

#### *Foreign Branches of Member Banks*

At the end of 1997, 89 member banks were operating 786 branches in foreign countries and overseas areas of the United States; 59 national banks were operating 599 of these branches, and 30 state member banks were operating the remaining 187 branches. In addition, 19 nonmember banks were operating 29 branches in foreign countries and overseas areas of the United States.

#### *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. Agreement corporations are state-chartered or federally chartered companies that enter into agreements 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 in most cases 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.

At year-end 1997, there were eighty-four Edge Act and agreement corporations with thirty domestic branches. During the year, the Federal Reserve examined all of these corporations.

### 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 1997, 278 foreign banks from 59 countries operated 412 state-licensed branches and agencies (of which 23 were insured by the FDIC) as well as 64 branches licensed by the OCC (of which 6 had FDIC insurance). These foreign banks also directly owned 16 Edge Act corporations and 3 commercial lending companies; in addition, they held an equity interest of at least 25 percent in 87 U.S. commercial banks. Altogether, these U.S. offices of foreign banks at the end of 1997 controlled approximately

20 percent of U.S. banking assets. These foreign banks also operated 148 representative offices; an additional 97 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 are examined on-site 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 446 examinations during 1997.

### 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 a joint program for supervising the U.S. operations of foreign banking organizations (FBOs). The program has two major parts. One part focuses on the examination process for those FBOs that have multiple U.S. operations and is intended to improve coordination among the various U.S. supervisory agencies.

The other 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 1997 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 1997 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 in 1997 issued for public comment an interim rule and several proposals to amend its capital adequacy guidelines. It also issued a proposal to amend its real estate appraisal rule for bank holding companies and their nonbank subsidiaries. During the year, the Federal Reserve continued to revise its supervisory process to enhance the effectiveness of examinations and inspections as well as to address changes in the banking industry. As part of these efforts, the Federal Reserve and the Federal Deposit Insurance Corporation jointly formalized and implemented a risk-focused supervision framework for the examination of community banks. The Federal Reserve also introduced a parallel framework for the risk-focused supervision of large, complex banking organizations.

## Capital Adequacy Guidelines

The risk-based capital requirements, adopted by the Federal Reserve in 1989, implement the international risk-based capital standards that were developed 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. The standards include a framework for calculating risk-adjusted assets and for assigning assets and off-

balance-sheet items to broad categories primarily on the basis of credit risk. In addition, some institutions must measure their market risk exposure and include that measure in their risk-based capital calculation. 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 issued leverage guidelines setting forth minimum ratios of capital to total assets to be used in the assessment of an institution's capital adequacy. During 1997, the Board of Governors approved for public comment an interim rule and several proposals to amend its capital adequacy guidelines.

### *Market Risk/Specific Risk*

On December 30, 1997, the Board, together with the FDIC and the OCC, issued an interim rule, effective at year-end 1997, along with a request for public comment, that amended their respective risk-based capital guidelines for market risk applicable to certain institutions having significant trading activities. The rule permits institutions to use qualifying internal models to determine their capital requirements in relation to specific risk (an element of market risk) without comparing the requirements generated by their internal models with the so-called standardized specific-risk capital requirement. The rule implements a revision to the Basle Accord that permits such treatment for institutions whose internal models adequately measure specific risk.

### *Recourse*

On November 5, 1997, the Federal Reserve, together with the OCC, FDIC, and OTS, issued a proposal to revise the risk-based capital standards to address

the regulatory capital treatment of recourse obligations and direct credit substitutes that expose banks, bank holding companies, and thrift institutions to credit risk. The proposed rules would use credit ratings to match the risk-based capital assessment more closely to an institution's relative risk of loss in certain asset securitizations.

#### *Unrealized Gains on Certain Equity Securities*

On October 23, 1997, the agencies issued a joint proposal to amend the risk-based capital standards for banks, bank holding companies, and thrift institutions with regard to the treatment of certain unrealized revaluation gains on certain equity securities. Under the proposal, institutions would be permitted to include in tier 2 capital up to 45 percent of their unrealized gains on certain available-for-sale equity securities.

#### *Servicing Assets*

On August 4, 1997, the agencies issued a proposal to amend their risk-based and tier 1 leverage capital guidelines for banks, bank holding companies, and thrift institutions to address the accounting treatment of servicing assets on both mortgage assets and financial assets other than mortgages. The proposal reflects changes in accounting standards for servicing assets made in Statement of Financial Accounting Standard (FAS) No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. FAS 125 extended the accounting treatment for mortgage servicing to servicing on all financial assets. The proposed amendment would raise the capital limitations on the sum of all mortgage servicing assets and purchased credit card rela-

tionships from 50 percent of tier 1 capital to 100 percent of tier 1 capital. The amendment would also allow the deduction of servicing assets on financial assets other than mortgages from tier 1 capital.

#### *Leverage Capital Ratios*

On October 27, 1997, the agencies issued for public comment a proposal addressing their leverage standards. Under the proposal, institutions rated a composite 1 under the Uniform Financial Institutions Rating System would be subject to a minimum 3.0 percent leverage ratio, and all other institutions would be subject to a minimum 4.0 percent leverage ratio. This change would simplify and streamline the leverage standards and make the agencies' rules uniform.

#### *Technical Modifications*

In October 1997, the agencies issued a proposal to amend their capital adequacy guidelines to eliminate differences among the agencies. The proposed amendments pertain to the risk-based capital treatment of presold one-to four-family residential properties, second liens on one- to four-family residential properties, and investments in mutual funds. The amendment would permit a 50 percent risk weight for construction loans on all presold one- to four-family residential properties. All first and second liens would be treated separately, with qualifying first liens risk-weighted at 50 percent and non-qualifying first liens and all second liens risk-weighted at 100 percent. At their option, institutions would be permitted to assign mutual fund investments on a pro rata basis among the risk categories according to the investment limits in the mutual fund prospectus.

## Real Estate Appraisal Regulation

In 1990, in accordance with title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, the Board, along with the other federal banking agencies, adopted appraisal regulations for real estate-related transactions within their jurisdiction and exempted certain transactions from the regulations. In 1994 the agencies amended several existing exemptions and added several new exemptions. On December 5, 1997, the Board issued a proposal to amend its real estate appraisal regulation for bank holding companies and their nonbank subsidiaries. The proposed amendment would permit a bank holding company or its nonbank subsidiary having the authority to underwrite or deal in mortgage-backed securities to do so without demonstrating that the loans underlying the securities are supported by appraisals that at origination met the Board's appraisal regulation. The Board proposed this amendment to address concerns raised by bank holding companies regarding the inability of their nonbank subsidiaries to actively participate in the commercial mortgage-backed securities market because of the Board's appraisal requirements. A final amendment is expected in early 1998.

## Risk-Focused Supervision

Over the past several years the Federal Reserve has initiated a number of programs aimed at enhancing the effectiveness of the supervisory process. The main objective of these initiatives has been to sharpen the focus on (1) those business activities posing the greatest risk to banking organizations and (2) the organizations' management processes for identifying, measuring, monitoring, and controlling their risks.

## *Risk-Focused Supervision of Banks*

In October 1997, the Federal Reserve formally implemented two risk-focused supervision programs for banks, one for large, complex banking organizations and the other for community banks. Both programs rely on an understanding of the institution, the performance of risk assessments, the development of a supervisory plan, and examination procedures tailored to the institution's risk profile.

*Large, complex banks.* For large, complex organizations, the supervision program emphasizes the need for ongoing supervision, through increased planning and off-site monitoring, and for coordination of supervisory activities with an organization's multiple regulators, to improve efficiency and avoid duplication. The program also emphasizes a review of functional activities or business lines, rather than just legal entities, because large organizations generally are structured according to business functions and manage many important financial and operational activities centrally. As part of this approach, the program endorses the concept of conducting, when appropriate, a series of targeted examinations during a given supervisory cycle, each focusing on a single function or business line.

*Community banks.* The supervisory framework for community banks was developed jointly by the Federal Reserve and the FDIC in close consultation with state bank supervisors. The program sets forth guidelines for planning and scoping examinations to focus on the areas of highest risk to the bank and encourages the performance of as many supervisory activities as possible off-site. It also describes general procedures for examining each of the major

areas of a bank's risk-bearing activities. The procedures are set forth in modules that are structured in a decision-tree format. This format allows an examiner to draw conclusions about a particular activity after completing a core analysis, which in most cases would require only a few procedures. If the core analysis indicates that a more in-depth review and more testing are needed to draw a conclusion about a particular activity, the examiner would perform an expanded analysis. To aid in conducting risk-focused examinations, an automated program has been developed that allows examiners to document their work for each module on their laptop computers. The program, which also provides electronic access to the FDIC and Federal Reserve examination manuals, is designed to operate on all computers currently used by FDIC, Federal Reserve, and state bank supervisors.

#### *Risk-Focused Supervision of Small Shell Bank Holding Companies*

In November 1997, the Board adopted a risk-focused supervision program for small shell bank holding companies that tailors supervisory activities to an assessment of each company's reported condition and activities and the condition of its subsidiary banks. Under the program, Reserve Banks are expected to perform a risk assessment of each small shell bank holding company at least once during each supervisory cycle, which depends on the examination frequency for the holding company's lead bank. If the preliminary assessment identifies no unusual supervisory issues or concerns, no special follow-up with the company is necessary. However, if it supports the assignment of a supervisory rating (that is, a BOPEC rating) of 3 or worse or a management rating of less than satisfactory, a full-scope,

on-site inspection is expected to be performed. Newly formed companies will still be subject to a full-scope, on-site inspection within the first twelve to eighteen months of operation.

#### Examination-Frequency Guidelines

In February 1997, the Board and the other banking agencies revised their examination-frequency guidelines to address provisions in the Riegle Community Development and Regulatory Improvement Act of 1994 and the Economic Growth and Regulatory Paperwork Reduction Act of 1996. As a result of the revision, certain banks having assets of less than \$250 million will be subject to an eighteen-month examination cycle rather than a twelve-month cycle. To qualify for less-frequent examination, a bank must be rated composite 2 or better, must be well capitalized and well managed, must not be subject to a formal enforcement action, and must not have experienced a change of control during the preceding twelve months.

#### Risk-Management Guidance

In June 1997, in response to an amendment to the Basle Accord on capital requirements for exposure to general market risk, the Federal Reserve issued guidance on the risk-based capital treatment of credit derivatives held in trading accounts. Banking organizations are expected to hold risk-based capital to compensate for exposure to counterparty credit risk, general market risk, and specific risk in credit derivative transactions.

In July 1997, the Board issued guidance on the risk management and capital adequacy of secondary-market credit activities such as loan syndications, loan sales and participations, credit

derivatives, and asset securitizations and the provision of credit and liquidity enhancements to transactions in these areas. The guidance identifies some of the significant risks involved in several of the more common types of secondary-market credit activities. It also describes sound practices and special considerations that supervisors should take into account when assessing a banking organization's systems for managing risks arising from these activities.

### Derivatives Accounting and Disclosures

During 1997 the Federal Reserve provided comments on the Financial Accounting Standards Board's (FASB) proposed standard Accounting for Derivative and Similar Financial Instruments and for Hedging Activities. Although the Federal Reserve supports the FASB's objective of promoting greater transparency in financial statements, the Board's comment letters expressed concerns that the FASB approach would not improve the transparency of financial reporting and would likely constrain prudent risk-management practices that make use of derivatives. The Federal Reserve offered the FASB suggestions for improving the transparency of financial reporting for derivatives and all other financial instruments. In conjunction with the Basle Committee on Banking Supervision, similar comments were provided to the International Accounting Standards Committee (IASC) regarding its accounting proposal for financial instruments.

Industry groups and regulators continued during 1997 to monitor the quality of bank disclosures of derivatives activities, with the goal of making these activities more transparent to the public

and to regulatory authorities. In November, the Basle Supervisors Committee and the Technical Committee of the International Organisation of Securities Commissions (IOSCO) issued a third joint report on the public disclosure of trading and derivatives activities of banks and securities firms worldwide. The report provides an overview and analysis of the disclosures about trading and derivatives activities presented in the 1996 annual reports of a sample of the largest internationally active banks and securities firms in the G-10 countries, and notes improvements since 1993.<sup>3</sup> The analysis was built in part on a framework used by the Federal Reserve in analyzing the trading and derivatives disclosures of major U.S. banking organizations. It revealed that a number of firms in the sample have continued to make general improvements, such as the expansion of value-at-risk disclosures, as well as significant voluntary innovations in their annual report disclosures. Despite these encouraging advances, however, some institutions have continued to disclose little about their trading and derivatives activities. The report also contains recommendations made by the Basle Committee and IOSCO in 1995 for further improvements in disclosures of qualitative and quantitative information about institutions' involvement in trading and derivatives activities, including their risk exposures and risk-management policies, and the effect of these activities on earnings.

### Bank Internal Audit Functions

In December 1997, the Board and the other federal banking regulators issued a joint policy statement that describes

---

3. The total sample consisted of seventy-nine global institutions holding more than \$83 trillion in derivative instruments (notional amounts).

sound practices for managing the internal audit function of banking organizations and includes a major section on internal audit outsourcing. The statement reiterates that directors and senior managers are responsible for ensuring that the system of internal control is adequate for the nature and scope of the organization's business. It provides examiners with guidance for assessing the quality and effectiveness of an organization's internal audit function. It also provides guidance on sound practices for internal audit outsourcing arrangements and on independence issues when an accountant plans to serve as the banking organization's external auditor and as its internal-audit outsourcing vendor.

### **Information Technology**

As described in previous sections, during 1997 the Federal Reserve formalized risk-based supervision programs for large, complex banking organizations and for community banking organizations. The Division of Banking Supervision and Regulation views the support of these programs as its most critical objective in deploying information technology. The risk-based programs require that (1) the division maintain a current risk profile of large, complex organizations subject to Federal Reserve supervision for the purpose of determining the appropriate supervisory strategy for ensuring safe and sound operations and (2) examination exercises for all organizations focus on areas of highest risk and be conducted in a manner that both leverages to the greatest extent possible upon existing management information systems and eliminates duplication of effort among regulators and bankers. During the year, the division made significant progress in the use of information technology to support these pro-

grams and implemented a process for focusing future development efforts on risk-based supervision. Several of these initiatives are discussed below.

#### **National Information Center and National Examination Database**

The National Information Center (NIC) is a Federal Reserve System database 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. The NIC contains information about the organizational structure of all depository institutions, nonbanks, bank holding companies, and foreign banking organizations operating in the United States. It also contains financial information such as Call Report data and Uniform Performance reports for depository institutions, and FR-Y financial reports and Uniform Performance reports for bank holding companies. In addition, the NIC contains supervisory information resulting from examinations and inspections and enables end users to perform financial analysis on institutions.

During 1997, work continued on software to improve NIC's usefulness through the use of distributed technologies. The National Examination Data (NED) software system was implemented in December. The system allows staff members to retrieve and update supervisory and financial information on depository institutions and bank holding companies. Development of the NED system, which was begun in 1995 to take advantage of the Federal Reserve System's intranet and to improve the functionality of the NIC through the use of client/server technology, will greatly facilitate the examination process, bank surveillance, and supervisory analysis. Implementation of similar technological

improvements to support other areas of the NIC began in 1996 and will continue, in several phases, through 1999. In addition, much progress was made in 1997 toward providing public access to nonconfidential NIC information. In January, a public Internet page was made available to provide access to many of the structure and financial reports contained in the NIC. The page is reached through the FFIEC home page and through a link on the Board of Governor's home page.

In 1998 and beyond, the Federal Reserve will make the NED system available to state banking agencies and will explore ways to use internet technologies to expand the availability of NIC data in general.

#### Foreign Banking Organization Desktop (FBO Desktop)

FBO Desktop is an automated system developed by the Federal Reserve to assist in the supervision of U.S. branches and agencies of foreign banking organizations. The system makes possible the sharing throughout the Federal Reserve System of information used in the supervision of foreign banking organizations, including information on foreign financial systems, foreign accounting standards, and analysis of the financial performance of foreign banking organizations having U.S. operations. The Federal Reserve plans in May 1998 to implement a similar system for large domestic banking organizations that includes more types of information. Also in 1998, access to these two systems will be extended to state and federal banking regulators.

#### Examination-Related Initiatives

In 1997, the Division of Banking Supervision and Regulation took several steps

to improve the use of automation in the conduct of examinations, notably through joint efforts with the FDIC and state bank supervisors. One step was development of the Examination Laptop Visual Information System (ELVIS). ELVIS leads examiners through a decision matrix to focus on high-risk activities and helps ensure consistency among examiners in the use of risk-focused procedures. Because it automatically documents the examination process, the system also provides cost savings.

Also during the year, the division agreed with the FDIC and state supervisors to use a common, automated tool for analyzing loans. Use of an automated loan-analysis tool saves considerable examination resources by expediting the selection of loans to be reviewed, eliminating the need to transcribe certain information available electronically at the bank, and facilitating greater portfolio analysis. The division also agreed with the FDIC and state supervisors on a system for accessing data to be used in conducting examinations and preparing examination reports. A production version of the system is expected to be ready in late 1998.

#### 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 the training sessions 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, and applications analysis.

Classes are 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 entire supervisory and regulatory process and thereby provide a higher degree of cross-training among staff members.

The System also participates in training offered by the Federal Financial Institutions Examination Council (FFIEC) and by certain other regulatory agencies. The System's involvement includes developing and implementing basic and advanced training in various emerging issues as well as in such specialized areas as trust activities, international

banking, information technology, municipal securities dealer activities, capital markets, payment systems risk, white collar crime, and real estate lending. In addition, the System co-hosts the World Bank Seminar for students from developing countries.

The Federal Reserve conducted a variety of schools and seminars in 1997, and staff members participated in several courses offered by or cosponsored with other agencies, as shown in the accompanying table.

In 1997 the Federal Reserve trained 4,199 students in System schools, 1,085 in schools sponsored by the FFIEC, and 84 in other schools, for a total of 5,368, including 256 representatives from for-

#### Number of Sessions of Training Programs for Banking Supervision and Regulation, 1997

Program	Total	Regional
<i>Schools or seminars conducted by the Federal Reserve</i>		
Core schools		
Introduction to examinations .....	8	6
Financial institution analysis .....	10	7
Bank management .....	7	3
Effective writing for banking supervision staff .....	19	19
Management skills .....	12	11
Conducting meetings with management .....	19	19
Other schools		
Loan analysis .....	6	5
Real estate lending seminar .....	5	3
Specialized lending seminar .....	3	...
Senior forum for current banking and regulatory issues .....	5	4
Banking applications .....	1	...
Bank holding company inspections .....	6	5
Basic entry-level trust .....	1	...
Advanced trust .....	1	...
Consumer compliance examinations I .....	2	...
Consumer compliance examinations II .....	3	...
CRA examination techniques .....	3	...
Fair lending .....	3	...
Information systems and emerging technology risk management ...	17	16
Information systems continuing education .....	2	...
Intermediate information systems examination .....	1	...
Capital markets seminars .....	16	12
Section 20 securities seminar .....	4	2
Internal controls .....	8	5
Seminar for senior supervisors of foreign central banks <sup>1</sup> .....	1	...
<i>Other agencies conducting courses<sup>2</sup></i>		
Federal Financial Institutions Examination Council .....	55	7
Office of the Comptroller of the Currency .....	3	...
Federal Bureau of Investigation <sup>3</sup> .....	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, and the Office of the Comptroller of the Currency.

eign central banks. A total of 26,608 student days of training were provided, comparable to the amount of training provided in recent years.

The Federal Reserve System also gave scholarship assistance to the states for training their examiners in Federal Reserve and FFIEC schools. Through this program 773 state examiners were trained: 458 in Federal Reserve courses, 302 in FFIEC programs, and 13 in other courses.

Every staff member seeking an examiner's commission is required to pass a core proficiency examination, which includes a core content area and a specialty area of the student's choice—safety and soundness, consumer affairs, trust, or information technology (formerly information systems). In 1997, 131 students took the examination (see table).

Late in the year, the System initiated revisions to the core training program that leads to the commissioning of assistant examiners. The project was undertaken to give assistant examiners a greater understanding of risk-focused examination concepts, the components of sound internal controls, the importance of management information systems, the concept of risk as it applies to banking, and the key supervisory issues related to integrated supervision. The changes will be implemented over 1998 and 1999.

**Federal Financial Institutions Examination Council**

**Year 2000**

The Federal Reserve is working closely with the other federal banking agencies to address the banking industry's readiness for the year 2000. The supervisory program focuses on the industry's efforts to ensure that automated systems will be able to correctly calculate date-dependent information after the century date change. The program has included the issuance of several policy statements, the development of a uniform set of examination procedures, and an outreach program that has provided numerous opportunities for banks and bank supervisors to discuss the issues. Year 2000 supervisory initiatives are continuing to intensify and have been of great interest to the industry, bank supervisors, and the Congress.

The banking agencies, through the FFIEC, issued two policy statements to all banks in 1997—"Year 2000 Project Management Awareness" on May 5 and "Safety and Soundness Guidelines Concerning the Year 2000 Business Risk" on December 17. The May statement included a set of uniform examination procedures that is being used in the Year 2000 examination of all banks subject to Federal Reserve supervision by mid-1998.

**Status of Students Registered for the Core Proficiency Examination, 1997**

Student status	Core	Specialty area			
		Safety and soundness	Consumer	Trust	Information technology
In queue, year-end 1996 .....	33	26	4	1	0
Test taken, 1997 .....	131	82	42	5	6
Passed .....	114	69	33	5	2
Failed .....	17	13	9	0	4
In queue, year-end 1997 .....	23	13	9	0	1

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

As part of its outreach activities, the Federal Reserve in June 1997 produced a ten-minute video entitled "Year 2000 Executive Awareness," which is intended for viewing by bank boards of directors and senior management. Governor Edward W. Kelley, Jr., introduces the video and emphasizes that the Year 2000 challenge is a business matter and not exclusively a technology problem, thus warranting the attention of boards of directors and senior officers.

In an effort to intensify international involvement by foreign bank supervisors, the Federal Reserve and other U.S. bank supervisors worked closely with the Bank for International Settlements's Committee on Banking Supervision to prepare a paper on the Year 2000 situation that was distributed in September 1997 to banks and bank supervisors in more than one hundred countries. The committee encouraged BIS member countries to make preparation for the year 2000 a priority to ensure that banks everywhere are ready for the century date change.

The Federal Reserve's supervisory activities and internal preparations have been of significant interest to both the House and the Senate Banking Committees as well as to the General Accounting Office. Staff members have been asked to provide quarterly written and oral briefings to both houses of Congress beginning with the third quarter of 1997 and continuing through the century date change.

### Revisions to the Call Report

During 1997 the FFIEC implemented changes to the bank Reports of Condition and Income (Call Reports) to adopt generally accepted accounting principles (GAAP) as the reporting basis in all areas of the Call Reports, effective with

the March 1997 report. This change brought the accounting principles used in bank regulatory reports into conformity with those used in bank holding company FR-Y reports, savings association Thrift Financial Reports, and general-purpose financial statements. The FFIEC also revised the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002), effective with the March 1997 report, and the Foreign Branch Report of Condition (FFIEC 030), effective with the September 1997 report, to adopt GAAP and certain other disclosures to maintain consistency with the bank Call Reports.

In October, the Federal Reserve and the other federal banking agencies proposed minor revisions to the bank Call Reports to improve the agencies' ability to monitor bank compliance with certain regulations and to facilitate bank supervision. The revisions would, with the March 1998 report, add items to monitor compliance with the risk-based capital standards for market risk exposures and low-level recourse transactions less frequently as part of the FFIEC's continuing efforts to reduce unnecessary regulatory burden and to streamline regulatory reports. The proposal would also eliminate several detailed items on bank trading portfolios and collect certain deposit information.

Besides implementing or proposing changes to Call Report content, the FFIEC in 1997 phased out the direct filing of Call Reports in paper form and implemented an electronic filing requirement. The FFIEC also revised the four versions of the Call Report instructions into a single set of instructions and made the report forms available on the Internet. These changes are consistent with the objectives of section 307 of the Riegle Community Development and Regulatory Improvement Act of

1994, which requires that the agencies work together to develop a single form for the filing of core information for banks, savings associations, and bank holding companies; to simplify instructions for such reports; and to develop a system under which such reports can be filed electronically.

## **Regulation of the U.S. Banking Structure**

The Board administers the Bank Holding Company Act, the Bank Merger Act, the Change in Bank Control Act, and the International Banking Act for bank holding companies, member banks, and foreign banking organizations. 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 international operations of domestic banking organizations; and the U.S. banking operations of foreign banks.

### **Bank Holding Company Act**

Under the Bank Holding Company Act, a company must obtain the Federal Reserve's approval before forming a bank holding company by acquiring control of one or more banks in the United States. Once formed, a bank holding company must receive the Federal Reserve's approval before acquiring additional banks or nonbanking companies. The act permits well-run bank holding companies that satisfy specific criteria to commence certain nonbanking activities on a *de novo* basis without prior Board approval and establishes 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 several 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, the potential public benefits, the competitive effects of the proposal, and the applicant's ability to make available to the Board information deemed necessary to ensure compliance with applicable law. In the case of a foreign banking organization seeking to acquire control of a U.S. bank, the Federal Reserve also considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor.

In 1997, the Federal Reserve approved 358 proposals by foreign or domestic companies to become bank holding companies; approved 108 proposals by existing bank holding companies to merge with other bank holding companies; approved 283 proposals by existing bank holding companies to acquire or retain banks; approved 398 requests by existing bank holding companies to acquire nonbank firms engaged in activities closely related to banking; and approved 90 other bank holding company applications or notices and denied 1. Data on these and all other 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 on by the appropriate federal banking agency. If the institution surviving the merger is a state member bank, the Federal Reserve has primary jurisdiction. Before acting on a proposed merger, the Federal Reserve considers factors relating to the financial

and managerial resources of the applicant, the future prospects of the existing and combined institutions, the convenience and needs of the community to be served, and the competitive effects of the proposal. It also considers the views of certain other agencies regarding the competitive factors involved in the transaction.

During 1997 the Federal Reserve approved 156 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 ensure comparable enforcement of the antitrust provisions of the Bank Merger Act. The Federal Reserve and those agencies have adopted standard terminology for assessing competitive factors in merger cases to ensure consistency in administering the act. The Federal Reserve submitted 994 reports on competitive fac-

tors to the other federal banking agencies in 1997.

### Change in Bank Control Act

The Change in Bank Control Act requires persons seeking control of a U.S. bank or bank holding company to obtain approval from the appropriate federal banking agency before completing the transaction. Under the act, the Federal Reserve is responsible for reviewing changes in control of state member banks and of bank holding companies. In doing so, the Federal Reserve reviews the financial position, competence, experience, and integrity of the acquiring person; considers the effect on the financial condition of the bank or bank holding company to be acquired; determines the effect on competition in any relevant market; assesses the completeness of information submitted by the acquiring person; and considers whether the proposal would have an

### Decisions by the Federal Reserve, Domestic and International Applications, 1997

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	Permitted	Approved	Denied	Approved	Approved	Permitted	
Formation of holding company .....	12	0	0	0	0	1	261	84	358
Merger of holding company .....	12	0	0	0	0	16	61	19	108
Acquisition of bank ..	25	0	0	0	0	22	155	81	283
Acquisition of nonbank .....	0	0	124	0	0	44	0	230	398
Merger of bank .....	23	0	0	0	0	17	116	0	156
Change in control ....	6	0	0	0	0	4	0	174	184
Establishment of a branch, agency, or representative office by a foreign bank .....	18	0	1	0	0	0	1	0	20
Other .....	363	1	58	19	0	169	1,395	129	2,134
<b>Total .....</b>	<b>459</b>	<b>1</b>	<b>183</b>	<b>19</b>	<b>0</b>	<b>273</b>	<b>1,989</b>	<b>717</b>	<b>3,641</b>

adverse effect on the federal deposit insurance funds.

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 agencies are also required to assess the qualification of each person seeking control. In early 1997, following discussions with the FDIC, the OCC, and the OTS, the Board adopted significant changes to the portion of Regulation Y that implements the Change in Bank Control Act. The modifications represent an attempt to reduce unnecessary regulatory burden and to harmonize the scope and procedural requirements of the Federal Reserve with those of the other federal banking agencies. As discussed in the later section "Recent Regulatory Changes," these revisions were part of a broader effort by the Board to improve Regulation Y.

In 1997 the Federal Reserve acted on 184 proposed changes in control of state member banks and bank holding companies.

### International Banking Act

The International Banking Act, as amended by the Foreign Bank Supervision Enhancement Act of 1991, requires Federal Reserve approval for the establishment of branches, agencies, commercial lending company subsidiaries, and representative offices by foreign banks in the United States.

In reviewing proposals, the Board generally considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor. It may also take into account whether the home country supervisor has consented to the establishment of the U.S. office;

the financial resources of the foreign bank and its existing U.S. operations; the managerial resources of the foreign bank; whether the home country supervisor shares information regarding the operations of the foreign bank with other supervisory authorities; whether the foreign bank has provided adequate assurances that information concerning its operations and activities will be made available to the Board, if deemed necessary to determine and enforce compliance with applicable law; and the record of the foreign bank with respect to compliance with U.S. law.<sup>4</sup>

In 1997, the Federal Reserve approved applications by fourteen foreign banks from twelve foreign countries to establish branches, agencies, and representative offices in the United States.

### Public Notice of Federal Reserve Decisions

Each decision by the Federal Reserve that involves a bank holding company, a bank merger, a change in control, or the establishment of a new U.S. banking presence by a foreign bank is effected by an order or an announcement. Orders state the decision, the essential facts of the application or notice, and the basis for the decision; announcements state only the decision. All orders and announcements are made public immediately; they are subsequently reported in the Board's weekly H.2 statistical release and in the monthly *Federal Reserve Bulletin*. The H.2 release also contains announcements of applications and notices received by the Federal Reserve but not yet acted on. In 1997, the H.2 release became available on the Board's public Web site.

---

4. The Board may also consider the needs of the community, the foreign bank's history of operation, and its relative size in its home country.

### Timely Processing of Applications

The Federal Reserve maintains target dates and procedures for the processing of applications. The setting of target dates promotes efficiency at the Board and the Reserve Banks and reduces the burden on applicants. The time allowed for a decision ranges from thirty to sixty days, depending on the type of application or notice. In 1997, 98 percent of decisions met this standard.

### Delegation of Applications

Historically, the Board of Governors 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 the Board and the Reserve Banks to work more efficiently by removing routine cases from the Board of Governors's agenda. In 1997, 82 percent of the applications processed were acted on under delegated authority.

### Recent Regulatory Changes

In February 1997, the Board approved significant revisions to Regulation Y, which implements the Bank Holding Company Act, the Change in Bank Control Act, and certain related statutes. The revisions were intended to improve the competitiveness of bank holding companies by eliminating unnecessary regulatory burden and operating restrictions and by streamlining the application and notice process. As part of the final regulation, the Board implemented a streamlined and expedited review process for bank and nonbank proposals by well-

run bank holding companies. The Board also reorganized and expanded the list of generally permissible activities of bank holding companies and updated or eliminated many of the restrictions under which bank holding companies conduct business. The final regulation also adopted a number of measures designed to broaden and improve public notice of acquisition proposals.

In December 1997, the Board requested comment on proposed comprehensive revisions to Regulation K, which governs international banking operations. The proposed revisions are intended to improve the international competitiveness of U.S. banking organizations by expanding permissible activities abroad and reducing regulatory burden associated with the conduct of such activities, and to reduce regulatory burden on foreign banks operating in the United States by streamlining the application and notice process.

### Banking and Nonbanking Proposals

During 1997, the Board approved several merger proposals involving some of the largest banking organizations in the United States. As in previous cases, these proposals generated many comments from the public, particularly with respect to Community Reinvestment Act, fair lending, and competitive issues. The Board also continued to process numerous banking proposals involving mutual holding companies.

Beginning in the second half of 1996, the Board adopted a series of changes in the restrictions applicable to the operations of section 20 subsidiaries. As a result of these changes, the Federal Reserve System in 1997 received significantly more proposals involving the establishment and expansion of section 20 subsidiaries by bank holding companies. By year-end 1997, the Board

had approved a variety of proposals by both foreign and domestic banking organizations to acquire full-service securities brokerage and investment firms. The number of section 20 subsidiary proposals from smaller banking organizations also increased.

In the course of acting on other nonbanking proposals by foreign and domestic bank holding companies, the Board continued to expand the scope of permissible data processing activities to facilitate electronic banking. It also permitted several banking organizations to acquire or retain certain operations engaged in a broad range of mutual fund activities.

#### Overseas Investments by U.S. Banking Organizations

U.S. banking organizations, with the authorization of the Board, may engage in a broad range of activities overseas. Most foreign investments may be made under general consent procedures that involve only after-the-fact notification to the Board; significant investments must be reviewed by the Board in advance. In 1997 the Board approved twenty-three proposals by U.S. banking organizations to make significant investments overseas.

The Board also has authority to act on proposals involving Edge Act and agreement corporations, which are established by banking organizations to provide a means of engaging in international business. In 1997 the Board approved two proposals to increase the investment by a member bank in its Edge corporation subsidiaries above 10 percent of the member bank's capital and surplus. These proposals were novel in that until September 1996, U.S. banks were prohibited from investing more than 10 percent of their capital and surplus in Edge and agreement corporations. At that

time, legislation was adopted that allows member banks to invest up to 20 percent of their capital and surplus with the prior approval of the Board. During 1997, the Board also approved two applications to establish new agreement corporations.

#### Applications by Member Banks

State member banks must obtain Board approval to establish domestic branches, and member banks (including national banks) must obtain Board approval to establish foreign branches. In considering proposals for domestic branches, the Board reviews the scope of the functions and the character of the business to be conducted. In reviewing proposals for foreign branches, the Board considers, among other things, the condition of the bank and the bank's experience in international business. Once a member bank has received authority to open a branch in a particular foreign country, the member bank may open additional branches in that country without prior Board approval. In 1997 the Federal Reserve acted on merger and new branch proposals related to 1,681 domestic branches and granted prior approval for the establishment of 10 foreign branches.

#### Stock Repurchases by Bank Holding Companies

A bank holding company may purchase its own shares from its shareholders. When the company borrows money to buy the shares, the transaction increases its debt and 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 1997 the Federal Reserve reviewed thirty-

seven proposed stock repurchases by bank holding companies, all of which were acted upon under delegated authority by either the Reserve Banks or the Secretary of the Board.

## **Enforcement of Other Laws and Regulations**

### **Financial Disclosure by State Member Banks**

State member banks that issue securities registered under the Securities Exchange Act of 1934 must disclose certain information of interest to investors, including financial reports and proxy statements. By statute, the Board's financial disclosure rules must be substantially similar to those of the Securities and Exchange Commission. At the end of 1997, twenty-eight state member banks, most of them small or medium sized, were registered with the Board 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 of creating and maintaining records of various financial transactions that otherwise would not be identifiable in efforts 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 that must be reported and maintained by financial institutions provide law enforcement authorities, as well as bank regulators, with data useful in detecting and preventing unlawful activity. The Federal Reserve, through its examination process and other off-site measures, monitors compliance with the Bank Secrecy Act by the institutions it supervises.

In 1997 the Federal Reserve issued revised and expanded procedures for its examinations for compliance with the Bank Secrecy Act that include new interagency anti-money-laundering examination procedures, as required by the provisions of section 404 of the Riegle Community Development and Regulatory Improvement Act of 1994. The enhancements include procedures that address compliance with anti-money-laundering rules, procedures to determine whether suspicious activities are being monitored and reported, procedures to assess training programs for all relevant staff in the areas of Bank Secrecy Act compliance and anti-money-laundering controls, and procedures that require bank examiners to address a banking organization's compliance with several regulations related to anti-money-laundering recently issued by the Department of the Treasury.

The Federal Reserve continued in 1997 to provide expertise and guidance to the Bank Secrecy Act Advisory Group, a committee established at the Department of the Treasury by congressional mandate to seek measures to reduce unnecessary Bank Secrecy Act burdens and to increase the utility of Bank Secrecy Act data to regulators. Also, through the Special Investigations Section of the Division of Banking Supervision and Regulation, the Federal Reserve has assisted in the investigation of money laundering activities and has provided anti-money-laundering training to designated staff members at each Reserve Bank as well as for law enforcement agencies and the banking sector. The Federal Reserve has also participated extensively in the Financial Action Task Force, which in 1997 provided anti-money-laundering training to numerous foreign governments and central banking authorities.

**Loans to Executive Officers**

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

**Federal Reserve Membership**

At the end of 1997, 3,543 banks were members of the Federal Reserve System. At that time, member banks were operating 45,037 branches and accounted for 39 percent of all commercial banks in the United States and for 73 percent of all commercial banking offices.

**Loans by State Member Banks to their Executive Officers, 1996 and 1997**

Period	Number	Amount (dollars)	Range of interest rates charged (percent)
<i>1996</i>			
October 1–December 31 .....	705	27,555,000	0.0–19.8
<i>1997</i>			
January 1–March 31 .....	735	31,815,000	0.0–18.0
April 1–June 30 .....	786	36,167,000	0.0–19.5
July 1–September 30 .....	743	37,229,000	0.0–18.0

SOURCE. Call Reports.

