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## *Banking Supervision and Regulation*

The overall condition of the U.S. banking system remained strong during 1998, though problems in certain emerging markets and the ensuing volatility in world financial markets posed challenges for larger, internationally active banks. For most banking organizations, profitability and asset quality remained robust, supported by the U.S. economic expansion. In contrast, several internationally active organizations reported reduced profitability and asset quality related to their foreign lending, trading, and investment-banking activities. Nevertheless, given the unusual severity of market volatility, the larger global firms showed remarkable resilience and, like the rest of the industry, generally maintained historically high capital ratios and adequate loss reserves.

Over the course of the year, industry consolidation continued as large and small banking firms sought to tap potential synergies and efficiencies. At the same time, competition to meet the rising demand for credit from businesses and consumers continued to intensify and to place pressure on loan terms and conditions. However, market volatility in the second half of the year caused many firms to reevaluate their practices, leading to a firming in the pricing and conditions for certain loan categories to reflect greater economic uncertainty.

As an important part of its supervisory role, the Federal Reserve has promoted the strengthening of bank risk-management systems, including the use of stress-testing. The recent turmoil in international financial markets has helped to underscore the need for improvement and has led many organizations to evaluate the underlying

assumptions and adequacy of their risk-management systems. More work will need to be done in this critical area for bank safety and soundness.

Recent events have also underscored the importance of capital for the safety and soundness of individual institutions and the stability of financial systems both here and abroad. Over the past decade, the international risk-based capital standards established in 1988 through the Basle Capital Accord have served the U.S. and international banking systems well. To preserve the usefulness of the standards, the Federal Reserve and other international supervisors are evaluating ways of modernizing the standards to better address changes in rapidly evolving financial markets, products, and institutions.

Toward that end, and as part of its overall supervisory efforts, the Federal Reserve has intensified its evaluation of the techniques that banks are using to monitor and quantify their risk exposures and to allocate capital. In particular, the Federal Reserve has dedicated resources to studying bank practices for establishing internal risk grades for loans and other exposures, bank statistical modeling techniques for quantifying credit risk, and evolving methods for quantifying operational risk. Work is also under way to understand the range of practices banks are employing to internally allocate capital among business lines and to establish their own target capitalization on a firm-wide basis.

These hands-on evaluations of bank risk-measurement and capital-allocation practices not only have improved our understanding of individual institution

safety and soundness, but have provided valuable comparative insights on the state of industry practices. These lessons are being shared with supervisors internationally and may serve as an important foundation in efforts to revise the capital standards that are now being considered by the Basle Committee on Banking Supervision.

In response to the increasing scope and complexity of banking activities, the Federal Reserve has not only intensified its focus on internal risk-management practices but has also placed greater emphasis on planning and examiner training, to ensure that supervisory efforts are targeted toward areas posing the highest risk to financial institutions. Work is also under way to provide staff with technology that facilitates more-continuous supervisory oversight and enables better coordination across Reserve Banks.

As part of its efforts to promote sound practices and to improve the quality and consistency of supervision, the Federal Reserve in 1998 undertook reviews of certain banking practices at several large institutions of similar size and characteristics. These coordinated supervisory reviews provided valuable comparative information on how well banking organizations are managing risk. For example, a detailed review of commercial lending standards at several of the largest banking organizations resulted in additional guidance to examiners and the industry. This review quantified trends in lending standards, described sound practices, and noted areas needing increased supervisory attention.

Along with these ongoing efforts to improve supervisory oversight and banking practices, the Federal Reserve has continued its extensive program for ensuring that institutions recognize their obligations to be ready for the century date change. During 1998, the Federal

Reserve reviewed every bank subject to its supervisory oversight for Year 2000 readiness. In addition, working with regulators both here and abroad, the Federal Reserve issued numerous public statements and held, as well as cosponsored, several conferences to provide guidance to the industry. Work in this area will continue throughout 1999.

Another significant area of supervisory attention during 1998 stemmed from the escalation of problems in certain Asian countries and the rapid spread of difficulties across other markets subsequent to the Russian bond default. In response to these problems, the Federal Reserve built on its strong relationships with domestic and international regulatory bodies to gain a better understanding of the extent of U.S. financial institutions' exposures to internationally active organizations and to formulate appropriate remedial actions. Efforts focused on both the foreign operations of U.S. banks in troubled economies and the U.S. operations of banks based in those countries.

These and other efforts detailed in this chapter form the basis by which the bank supervision function supports the Federal Reserve's mission of promoting financial stability, containing systemic risk, and providing a safe and sound banking system.

### **Scope of Responsibilities for Banking 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 regulations on consumer and community affairs.<sup>1</sup> The Federal Reserve also examines the specialized activities of these institutions, such as information technology, fiduciary activities, capital markets activities, and government securities dealing and brokering.

In addition, the Federal Reserve has responsibility for the supervision of all Edge Act and agreement corporations; the international operations of state member banks and U.S. bank holding companies; and 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. The Federal Reserve is

also 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 aspects of the reviews 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 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.

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 these laws and regulations. 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. Several regulatory organizations enforce compliance with the Board's securities credit regulations, which are administered by the Board's Legal Division.

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.

### *State Member Banks*

At the end of 1998, 994 state-chartered banks (excluding nondepository trust companies and private banks) were members of the Federal Reserve System. These banks represented about 11.4 percent of all insured U.S. commercial banks and held about 24.2 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. For most of these banks, a full-scope, on-site examination is required at least once during each twelve-month period; certain well-capitalized and well-managed institutions with assets of less than \$250 million may be examined every eighteen months.

During 1998, the Federal Reserve Banks conducted 540 examinations of state member banks (some of them jointly with the state agencies), and state banking departments conducted 293 independent examinations of state member banks.

### *Bank Holding Companies*

At year-end 1998, the number of U.S. bank holding companies totaled 5,979. These organizations controlled 6,829 insured commercial banks and held approximately 95.4 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. In judging the financial condition of subsidiary banks, Federal Reserve examiners con-

sult 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 1998, Federal Reserve examiners conducted 1,057 bank holding company inspections, 76 of which were conducted off site, and state examiners conducted 76 independent inspections. These inspections were conducted at 917 bank holding companies.

Certain small, noncomplex bank holding 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 1998, the Federal Reserve conducted 2,662 reviews of these companies.

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

In 1998, the Federal Reserve Banks recommended, and members of the Board's staff initiated and worked on, 103 enforcement cases involving 186 separate actions, such as cease-and-desist orders, written agreements, removal and prohibition orders, and civil money penalties. Of these, 35 cases involving 53 actions were completed by year-end.

One of the final actions taken by the Board of Governors with regard to the illegal activities of the Bank of Credit and Commerce International (BCCI) was an agreement with Clark Clifford and Robert Altman to settle the Board's allegations that Messrs. Clifford and Altman had engaged in violations of laws and regulations with regard to BCCI's fraudulent activities. In settlement of the Board's charges, Messrs. Clifford and Altman paid penalties of approximately \$5 million.

In other significant matters, the Board of Governors assessed civil money penalties totaling more than \$500,000. The Board also issued two formal enforcement actions against institutions that exhibited less than satisfactory progress in addressing Year 2000 deficiencies.

All final enforcement orders issued by the Board of Governors and all written agreements executed by the Federal Reserve Banks in 1998 are available to the public and can be accessed from the Board's public web site.

In addition to formal enforcement actions, the Federal Reserve Banks in 1998 completed fifty-eight 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, transfer agent activities, government and municipal securities dealing, and securities underwriting and dealing through so-called section 20 subsidiaries of bank holding companies. As part of the technology review, examiners in 1998 also conducted targeted reviews of preparedness for the century date change. The Federal Reserve also conducts special-

ized examinations of certain persons, other than banks, brokers, or dealers, who extend securities credit subject to the Board's margin regulations.

### *Information Technology*

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. These examinations are conducted in recognition of the importance of information technology to the financial industry and help to ensure that banking organizations conduct their operations in a safe and sound manner. During 1998, the Federal Reserve conducted 278 examinations that focused on information technology and electronic data processing systems. The Federal Reserve was also the lead agency on two examinations of large, multi-regional data processing servicers examined in cooperation with the other federal banking agencies.

### *Year 2000 Compliance*

The Year 2000 supervision program is divided into three phases and assesses the progress of three types of entities in preparing for the century date change: financial institutions, service providers, and software vendors. (The program is described more fully later in the discussion of the Federal Financial Institutions Examination Council.) Phase 1, which ended June 30, 1998, included the review of 1,569 financial institutions and 49 service providers and software vendors. Phase 2 began July 1, 1998, and will run through March 1999. By year-end 1998, reviews of 837 financial institutions and 28 service providers and

software vendors had been conducted as part of phase 2. Phase 3 is currently being developed and is to run from April 1999 until early 2000.

### *Fiduciary Activities*

The Federal Reserve has supervisory responsibility for institutions that together hold more than \$11.5 trillion of assets in various fiduciary capacities. This group of institutions comprises 319 state-chartered member banks and trust companies, 71 nonmember trust companies that are subsidiaries of bank holding companies, and 18 entities that are either branches or agencies of foreign banking organizations or Edge corporation subsidiaries of domestic banking institutions.

During on-site examination of an institution's fiduciary activities, examiners evaluate the institution's management and operations, including its asset and account management, risk management, and audit and control procedures, and review its compliance with laws, regulations, general fiduciary principles, and potential conflicts of interest. In 1998, Federal Reserve examiners conducted 219 on-site trust examinations.

### *Transfer Agents and Securities-Clearing Agencies*

The Federal Reserve conducts specialized examinations of those state member banks and bank holding companies that serve as 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. On-site examinations focus on the effectiveness of transfer agent operations and compliance with relevant securities regulations. During 1998,

Federal Reserve examiners conducted examinations at 53 of the 143 state member banks and bank holding companies that were registered as transfer agents.

In addition, during 1998, the Federal Reserve examined two state member limited-purpose trust companies that acted as national securities depositories to ensure the safety and soundness of their operations and their compliance with applicable laws and regulations. These institutions, which were registered as clearing agencies with the Securities and Exchange Commission, held dematerialized and immobilized securities in custody on behalf of participants and their customers and facilitated the settlement of securities transactions through electronic book entry accounting. During 1998, one of the institutions, the Participants Trust Company, which provided depository and settlement services for mortgage-backed securities, became a division of the other, the Depository Trust Company, which is the national securities depository for most corporate and municipal securities

### *Government and Municipal Securities Dealers and Brokers*

The Federal Reserve is responsible for examining the government securities dealer and broker activities of state member banks and foreign banks for compliance with the Government Securities Act of 1986 and with Department of the Treasury regulations. Thirty-six 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 1998, the Federal Reserve conducted fourteen examinations of broker-dealer activities in government securities at these institutions.

Under the Securities Act Amendments of 1975, the Federal Reserve is also responsible for the supervision of state member banks and bank holding companies that act as municipal securities dealers. The Federal Reserve supervises thirty-six banks that act as municipal securities dealers. In 1998, thirteen of these institutions were examined.

### *Securities Subsidiaries of Bank Holding Companies*

All subsidiaries of bank holding companies established pursuant to section 20 of the Banking Act of 1933 are required to conduct business subject to uniform operating standards, consistent with safe and sound operations. To ensure that section 20 firms will not be engaged principally in underwriting and dealing in securities, the Board limits revenues derived from such activities to less than 25 percent of the total revenues of the section 20 subsidiary.

As the structure of the financial services industry has continued to evolve, a trend toward acquisition of independent securities firms by banking organizations has emerged. As a result, significant Federal Reserve resources have been devoted to monitoring and supervising such mergers and acquisitions to ensure that banking organizations develop and maintain the necessary risk management and corporate oversight to avoid any negative effect on the banking organization and its banking operations.

At year-end 1998, forty-six bank holding companies and foreign banking organizations owned a total of fifty-three section 20 subsidiaries authorized to underwrite and deal in ineligible securities; largely because of mergers and acquisitions, six of these institutions owned more than one section 20 subsidiary. Of the forty-six, thirty-five were permitted to underwrite any debt or

equity security, two were permitted to underwrite any debt security, and nine were permitted to underwrite only the limited types of debt securities first approved by the Board in 1987. The Federal Reserve follows specialized inspection procedures to review the operations of these securities subsidiaries; it conducted twenty-three such inspections in 1998.

### *Securities Credit Regulation*

Under the Securities Exchange Act of 1934, the Federal Reserve Board is responsible for regulating credit in certain transactions involving the purchase or carrying of securities. In addition to examining banks under its jurisdiction for compliance with the Board's margin regulations as part of its general examination program, the Federal Reserve maintains a registry of persons other than banks, brokers, and dealers who extend credit subject to the Board's margin regulations. The Federal Reserve may conduct specialized examinations of these lenders if they are not already subject to supervision by the Farm Credit Administration, the National Credit Union Administration, or the Office of Thrift Supervision.

At the end of 1998, 829 lenders other than banks, brokers, or dealers were registered with the Federal Reserve; of these, 584 were under the Federal Reserve's supervision. The Federal Reserve regularly inspects 270 of these lenders either biennially or triennially, according to the type of credit they extend; during 1998, Federal Reserve examiners inspected 143 of them for compliance with Regulation U. The remaining 314 lenders were exempt from periodic on-site inspections by the Federal Reserve but were monitored through the filing of periodic regulatory reports.

## International Activities

### *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 1998, the Federal Reserve conducted examinations of nine foreign branches of state member banks and eighty-two 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 twenty-three 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 1998, eighty-three member banks were operating 881 branches in foreign countries and overseas areas of the United States; fifty-three national banks were operating 693 of these branches, and thirty state member banks were operating the remaining 188 branches. In addition, twenty-two nonmember banks were operating 47 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 similar organizations, state-chartered or federally chartered, that enter into agreements with the Board not to exercise any power that is impermissible for an Edge Act corporation.

Under sections 25 and 25A 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 may invest in foreign financial organizations, such as finance companies and leasing companies, as well as in foreign banks.

At year-end 1998, there were eighty-five Edge Act and agreement corporations with thirty-three 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, commercial banks, and certain nonbank companies. Foreign banks continue to be significant participants in the U.S. banking system. As of year-end 1998, 246 foreign banks from 58 countries operated 421 state-licensed branches and agencies (of which 20 were insured by the Federal Deposit Insurance Corporation) as well as 62

branches licensed by the Office of the Comptroller of the Currency (of which 6 had FDIC insurance). These foreign banks also directly owned 15 Edge Act corporations and 3 commercial lending companies; in addition, they held an equity interest of at least 25 percent in 65 U.S. commercial banks. Altogether, these U.S. offices of foreign banks at the end of 1998 controlled approximately 20 percent of U.S. banking assets. These foreign banks also operated 216 representative offices; an additional 87 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 or eighteen-month period, either by the Federal Reserve or by a state or other federal regulator. On-site examinations of state- and federally licensed branches and agencies are usually conducted at least once during a twelve-month period, but the period may be extended to eighteen months if the branch or agency meets certain criteria. The Federal Reserve conducted or participated with state and federal regulatory authorities in 431 examinations during 1998.

*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 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 1998, 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 1998, the Federal Reserve System continued to provide staff for technical assistance missions covering bank supervisory matters to an increasing number of central banks and supervisory authorities around the world. Technical assistance takes a wide variety of forms, ranging from official visits by foreign supervisors to the Board and Reserve Banks for the purpose of learning about U.S. supervisory practices and procedures to secondments of Federal Reserve System staff to overseas supervisory authorities for the purpose of advising on strengthening the bank supervisory process in a foreign country. In 1998, technical assistance was concentrated primarily in Latin America, the Far East, and former Soviet bloc countries. During the year, the Federal Reserve offered supervision training courses in Washington, D.C., and on site in a number of foreign jurisdictions exclusively for staff of foreign supervisory authorities. System staff also took part in technical assistance and training missions led by the International Monetary Fund, the World Bank, the Inter-American Development Bank, and the Basle Committee on Banking Supervision.

## 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.

In 1998, the Federal Reserve continued to revise its supervisory process to improve the effectiveness of its examinations and inspections as well as to address changes in the banking industry. As of October 1, 1998, pre-membership examinations of state nonmember banks, national banks, and savings associations seeking to convert to state membership status are no longer required if the bank or savings association seeking membership meets the criteria for "eligible bank" as set forth in the Board's Regulation H.

During the year, two of the Federal Reserve's risk-focused supervision programs for banks—one for large, complex banking organizations and the other for community banks—were reviewed for effectiveness and the need for further enhancements. Both programs rely on gaining an understanding of the institution, performing risk assessments, developing a supervisory plan, and tailoring examination procedures to the institution's risk profile.

### *Risk-Focused Supervision of Community Banks*

Implementation of the risk-focused supervision program for community banks was reviewed at each of the twelve Reserve Banks. The primary objective was to identify best practices,

procedures, and processes as well as those that might require improvement or further clarification. The reviews emphasized that certain elements are key to the risk-focused supervision process, including adequate planning time, completion of a pre-examination visit, preparation of a detailed scope-of-examination memorandum, thorough documentation of the work done, and preparation of an examination report tailored to the scope of the examination. The findings from the reviews are expected to be distributed to the Reserve Banks in early 1999.

### *Risk-Focused Supervision of Large, Complex Banking Organizations*

In an effort to build on the Federal Reserve's Framework for Risk-Focused Supervision of Large, Complex Financial Institutions, a group of Reserve Bank and Board senior supervisory staff in 1998 codified best practices across the System for supervising the largest, most complex of these financial institutions. The key features of the program for implementing risk-focused supervision at these large, complex banking organizations (LCBOs) are (1) identifying those LCBOs that, based on their shared risk characteristics, present the highest level of supervisory risk to the Federal Reserve System; (2) maintaining continual supervision of these LCBOs to keep current the Federal Reserve's assessment of each organization's condition; (3) instituting a defined, stable supervisory team for each LCBO composed of Reserve Bank staff who have skills appropriate for the organization's unique risk profile, led by a Reserve Bank central point of contact who has responsibility for only one LCBO, and supported by specialists skilled in evaluating the risks of highly complex LCBO business activi-

ties and functions; and (4) promoting information-sharing on a Systemwide and interagency basis through an automated system.

### *Technology Initiatives for the Risk-Focused Supervision Program*

To assist in the supervision of large U.S. banking organizations and the U.S. branches and agencies of foreign banking organizations, the Federal Reserve in 1998 introduced the Large Bank Desktop and expanded the FBO Desktop. These automated systems are vehicles for sharing information used in the supervision of these organizations throughout the Federal Reserve System and with other federal and state banking supervisors.

Additionally, development of the Banking Organization National Desktop (BOND) has begun, with the aim of providing the high degree of information-sharing and ongoing collaboration necessary to support the risk-focused supervision of the largest, most complex banking organizations. BOND will expand on the capabilities of the Large Bank and FBO Desktops to provide immediate, user-friendly access to a full range of internal and third-party information and to risk-assessment and other decision-support tools. It will also serve to foster collaboration among Federal Reserve staff and other bank supervisors. BOND is expected to facilitate the analysis of trends for like organizations and to improve the Federal Reserve's ability to identify and manage the risks posed by these banking organizations.

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

During 1998, the Board implemented surveillance screens for small shell bank

holding companies that identify trends that may adversely affect individual companies. These screens support the risk-focused supervision program for small shell bank holding companies, which 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 a 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. New companies will still be subject to a full-scope, on-site inspection within the first twelve to eighteen months of operation.

### 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. This is accomplished, in part, through the use of automated screening systems. Surveillance screens address a number of aspects of banking performance, including capitalization, growth, loan quality, loan concentrations, liquidity, and capital markets activities. Information from these screens assists in allocating examination resources to deteriorating institutions and is also used in planning examinations. The systems used to monitor bank performance include two econo-

metric models that use quarterly Call Report data to estimate examination ratings for all banks and to identify banks having the potential to become critically undercapitalized over the subsequent two years.

During 1998, the Federal Reserve also initiated efforts to refine reports used in monitoring the international activities of domestic and foreign banking organizations. These efforts included expanding stock price monitoring efforts for global institutions and enhancing reports on the foreign exposure of U.S. banking institutions.

In addition, the Federal Reserve broadened the supervisory staff's electronic access to data on U.S. branches and agencies of foreign banking organizations through enhancements to the Performance Report Information and Surveillance Monitoring application (PRISM). PRISM is a PC-based application that supports financial analysis by facilitating access to supervisory and structure data housed in the National Information Center (NIC) and by electronically distributing surveillance and monitoring results.

To assist supervisory staff in evaluating individual bank holding companies, the Federal Reserve produces and distributes the quarterly Bank Holding Company Performance Report (BHCPR). This report includes detailed information on current and historic bank holding company conditions and performance. During the year, the Federal Reserve implemented a web version of the BHCPR to make nonconfidential versions of the report more accessible to the public.

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

## **Supervisory Policy**

The supervisory policy function develops guidance for examiners and financial institutions as well as regulations for financial institutions under the supervision of the Federal Reserve. Supervisory function staff members also participate in international supervisory forums and provide significant support for the work of the FFIEC. The following discussion summarizes the work of this function.

### **Trading and Capital Markets Activities**

In 1998, the Board's Division of Banking Supervision and Regulation issued a significantly revised and expanded version of its *Trading and Capital Markets Activities Manual*, which provides examiners with guidance for reviewing capital markets and trading activities at financial institutions of all types and sizes. The revised guidance takes a functional approach to activities, as opposed to a legal-entity focus. The manual includes new chapters on basic treasury functions and other capital markets activities, capital adequacy, and settlement risk and contains thirty-five new profiles of capital markets products. Chapters on market risk, pre-settlement risk, legal risk, financial performance, accounting and regulatory reporting, and ethics have been revised and updated to reflect new regulatory guidance and best practices.

The manual codifies current procedures used in reviewing capital markets and trading activities. It discusses the risks involved in various activities, risk-management and risk-measurement techniques, appropriate internal controls, and examination objectives and procedures. The manual is updated

periodically as products and activities evolve.

### Capital Adequacy Guidelines

During 1998, the Federal Reserve, together with the other federal banking agencies, issued two final rules that amended their capital standards. One rule permits institutions to include up to 45 percent of unrealized gains on certain equity securities in tier 2 capital. The other raises the tier 1 capital limitation for mortgage-servicing assets from 50 percent to 100 percent of tier 1 capital.

### Market Risk/Specific Risk

During 1998 the Federal Reserve, together with the FDIC and the OCC, worked to develop a final rule to amend their respective risk-based capital standards for market risk applicable to certain institutions having significant trading activities. The rule would finalize an interim rule issued by the agencies in December 1997. The interim 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 final rule being developed, which is similar in substance to the interim rule, is expected to be finalized in early 1999.

### Servicing Assets

On August 10, 1998, the federal banking agencies issued a final rule amending their risk-based and tier 1 leverage capital guidelines for banks, bank holding companies, and thrift institutions to address the accounting treatment of ser-

ving assets on both mortgage assets and financial assets other than mortgages. The final rule 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 extends the accounting treatment for mortgage servicing to servicing on all financial assets. The final rule raises the capital limitations on the sum of all servicing assets (mortgage and nonmortgage) and purchased credit card relationships (PCCRs) from 50 percent of tier 1 capital to 100 percent of tier 1 capital. It also subjects nonmortgage servicing assets and PCCRs to a further sublimit of 50 percent of tier 1 capital.

### Unrealized Gains on Certain Equity Securities

On September 1, 1998, the federal banking agencies issued a joint final rule that amended the risk-based capital rules and allows banking organizations to include up to 45 percent of their net unrealized holding gains on certain available-for-sale equity securities in tier 2 capital. The rule became effective on October 1, 1998. The full amount of net unrealized gains on available-for-sale securities is included as a component of equity capital under U.S. generally accepted accounting principles (GAAP), but until the adoption of this interagency rule such gains had not been included in regulatory capital. The agencies' capital rules, consistent with GAAP, continue to require banking organizations to deduct the amount of net unrealized losses on their available-for-sale equity securities from tier 1 capital. To be consistent with a restriction in the Basle Accord, the agencies have limited the inclusion of net unrealized gains on

equity securities in tier 2 capital to no more than 45 percent of such net unrealized gains.

### Leverage Capital Ratios

On June 4, 1998, the Federal Reserve issued a final rule that amended its leverage standard for bank holding companies. Under the rule, bank holding companies that either are rated a composite 1 under the BOPEC rating system or have implemented the Board's risk-based capital market risk measure are subject to a minimum 3 percent leverage ratio. All other bank holding companies are subject to a minimum 4 percent leverage ratio.

### Accounting for Derivative Instruments and Hedging Activities (FAS 133)

On December 29, 1998, the federal banking agencies issued a joint release that describes the appropriate interim regulatory capital treatment of derivatives for those banking organizations choosing to early-adopt Statement of Financial Accounting Standard (FAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Banking organizations are not required to adopt FAS 133 until fiscal years beginning after June 15, 1999. The new accounting standard requires that all derivatives be recorded on the balance sheet as assets or liabilities at fair value. It also requires that a specific portion of cash flow hedges be reflected as a separate component of equity. Moreover, it significantly alters the accounting for derivatives used for hedging purposes and for financial instruments having specific types of embedded derivatives.

The interagency guidance states that until the agencies determine otherwise, the separate component of equity capital

resulting from cash flow hedges should not be included in regulatory capital. The guidance further notes that the existing risk-based capital treatment for derivatives affects a banking organization's risk-based and tier 1 capital leverage ratios. The changes in the fair value of derivatives may indirectly affect retained earnings, thus affecting tier 1 capital. In addition, the on-balance-sheet recorded amount of derivatives may affect the total assets reported by banking organizations, thus directly affecting the leverage ratio.

### Development of International Guidance on Supervisory Policies

As a member of the Basle Committee on Banking Supervision (Basle Supervisors Committee) and the Joint Forum on Financial Conglomerates (Joint Forum), the Federal Reserve has a key role in developing supervisory guidance on a wide range of international supervisory policies. The Federal Reserve's goal is to work toward the adoption and implementation of sound supervisory policies for banking institutions and to ensure the stability of the international banking system. During 1998, the Federal Reserve actively played a central role in developing a number of supervisory policy papers, reports, and recommendations that were issued, or are in the process of being issued, by the Basle Supervisors Committee and the Joint Forum, including the following:

- The Basle Committee undertook in the latter part of 1998 a major effort to revisit the various parts of the Basle Accord to ensure the continued vigor of this international capital framework. The Committee is considering this issue in light of changes in financial institutions and their activities in the financial markets, as well as

the development of advanced risk management approaches, since the Accord's adoption in 1988.

- The Basle Committee undertook to study banking institutions' interaction with highly leveraged institutions (HLIs) such as hedge funds, particularly in light of the near-collapse of Long-Term Capital Management. A major part of this work was to assess the quality of banking institutions' risk-management practices related to HLIs and appropriate supervisory responses to address any weaknesses identified.
- The Basle Committee issued in October 1998 an interpretation of the Accord for capital adequacy regarding the capital instruments eligible for inclusion in tier 1 capital. The interpretation set forth the essential characteristics that capital instruments must have to warrant their inclusion in tier 1 capital under the Accord.
- The Basle Committee published in September 1998 the results of its survey of major banking institutions in member countries on their approaches to measuring, monitoring, and controlling operational risks arising from their financial activities.
- The Basle Committee conducted a survey on cross-border supervision focusing on two principal issues: access by home country supervisors to information on the activities of home country banking institutions in other countries, and the ability of supervisors to conduct cross-border inspections.
- In 1998, the Basle Committee extensively developed a consultative paper setting forth essential principles for the measurement and management of credit risk.
- The Joint Forum, with international participation by supervisors of the banking, securities, and insurance

industries, continued its work toward improving supervisors' cooperation and coordination in an effort to ensure the sound oversight of international financial conglomerates crossing national and traditional industry lines.

### Recourse

During 1998, the Federal Reserve, together with the OCC, FDIC, and OTS (Office of Thrift Supervision), continued to work on revisions to the rules regarding 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 revisions 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.

### Technical Modifications

The federal banking agencies continued in 1998 to work to amend their capital adequacy guidelines to eliminate differences among the agencies. At year-end 1998, several technical modifications were still outstanding. These addressed the risk-based capital treatment of (1) construction loans for presold one- to four-family residential properties, (2) second liens on one- to four-family residential properties, and (3) investments in mutual funds and to simplify the agencies' leverage capital rules for banks and thrifts. The first proposal would permit a 50 percent risk weight for construction loans on all presold one- to four-family residential properties. The second proposal would treat first and second liens issued by the same institution (where there are no intervening liens) as a single extension of credit for purposes of determining loan-to-

value percentages as well as risk weighting. These two proposed amendments would not change current Federal Reserve treatment of these assets for capital purposes. For investments in mutual funds, the proposed amendments would give institutions the option of assigning mutual fund investments on a pro rata basis among the risk categories according to the investment limits in the mutual fund prospectus. With regard to the tier 1 leverage ratio, the proposed amendment on mutual funds would permit certain institutions with the highest supervisory rating to have a 3 percent minimum leverage ratio; all other banks and thrift institutions would be required to have a minimum leverage ratio of 4 percent. The agencies are working to finalize these proposed amendments in early 1999.

#### Interagency Statement on the Allowances for Loan Losses

In November, the Federal Reserve, the Securities and Exchange Commission, and the other federal banking agencies issued a joint interagency statement on allowances for the loan losses of depository institutions. The statement reiterates the agencies' position that allowances for loan losses should be established and maintained in a manner that is consistent with generally accepted accounting principles and with the banking agencies' December 1993 interagency policy statement on the allowance for loan losses. The joint statement emphasizes the importance of prudent, conservative, but not excessive loan-loss allowances that fall within an acceptable range of estimated losses. The statement also states that the agencies will continue to fulfill their responsibility to ensure that allowances for loan losses are appropriately determined and that earnings are not improperly

managed, consistent with the objectives of safety and soundness and investor protection.

#### Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure

The Board and the other federal banking agencies in December 1998 issued a joint policy statement regarding intercompany tax allocations for banking organizations and savings associations that file an income tax return as a member of a consolidated group. The statement provides guidance to institutions regarding the allocation and payment of taxes among a bank holding company and its depository institution subsidiaries, and related internal policies. In general, the guidance is consistent with the Federal Reserve's pre-existing policies on income taxes, but it has been updated to reflect current tax terminology and to ensure a uniform interagency approach. Consistent with long-standing policy, the statement adheres to the general principle that intercorporate tax settlements between an institution and its parent company should be conducted in a manner that is no less favorable to the institution than if it were a separate taxpayer.

#### International Guidance on Internal Control, Accounting, and Disclosures

As a member of the Basle Committee on Banking Supervision (Basle Supervisors Committee), the Federal Reserve has a key role in the development of supervisory guidance on best accounting and best reporting practices among banking organizations. The objectives of this guidance are to promote greater transparency in financial statements, to encourage sound risk management, and

to improve disclosures of qualitative and quantitative information on bank risk exposures and risk-management policies and practices. During 1998, the Federal Reserve contributed to several papers and reports on internal controls, accounting, and disclosure that were issued by the Basle Supervisors Committee:

- “Framework for Supervisory Information about Derivatives and Trading Activities” (September) discusses the types of information supervisory authorities should obtain for their evaluations of the derivatives activities of banks and securities firms. The paper builds on the supervisory information framework that was jointly published in May 1995 by the Basle Supervisors Committee and the Technical Committee of the International Organization of Securities Commissions (IOSCO) and addresses more comprehensively the market risk exposures arising from trading in both cash and derivatives instruments.
- “Enhancing Bank Transparency: Public Disclosure and Supervisory Information That Promote Safety and Soundness in Banking Systems” (September) discusses the role of information in effective market discipline and banking supervision. It provides general guidance to banking supervisors and regulators on ways to formulate and improve regulatory frameworks for public disclosure and supervisory reporting; it also provides general guidance to the banking industry on core disclosures that should be provided to the public.
- “Framework for Internal Control Systems in Banking Organizations” (September) outlines a comprehensive framework for the supervisory evaluation of banks’ internal controls, including management’s responsi-

bility for maintaining the system of internal control, the role of the board of directors in establishing a corporate culture that emphasizes the importance of internal controls, and the monitoring activities and communication systems that are necessary to correct deficiencies. It also includes principles to guide supervisory authorities when evaluating banks’ internal control systems.

- “Sound Practices for Loan Accounting, Credit Risk Disclosure and Related Matters” (October) provides guidance to banks, banking supervisors, and those who set accounting standards on the recognition and measurement of loans, the establishment of allowances for loan losses, credit risk disclosure, and related matters.
- “Trading and Derivatives Disclosures of Banks and Securities Firms: Results of the Survey of 1997 Disclosures” (November) is the fourth annual joint report of the Basle Supervisors Committee and IOSCO 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 1997 annual reports of a sample of the largest internationally active banks and securities firms in the G-10 countries, and notes improvements since 1993.

In addition, a Federal Reserve official is a participating observer at meetings of the Financial Accounting Standards Board’s (FASB) Financial Instruments Task Force. The task force was created to help the FASB answer questions related to its accounting and disclosure standards for financial instruments. This Federal Reserve official is also a participating observer at the board and steering committee meetings of the

International Accounting Standards Committee (IASC) as a designee of the Basle Committee's Task Force on Accounting Issues. The IASC's objectives are to formulate and publish, in the public interest, accounting standards to be observed in the presentation of financial statements and to promote their worldwide acceptance and observance; and to work generally for the improvement and harmonization of regulations, accounting standards, and procedures relating to the presentation of financial statements.

### Real Estate Appraisal Regulation

In November 1998, the Board adopted a final rule amending its real estate appraisal regulation for bank holding companies and their nonbank subsidiaries. The final rule permits 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 amendment addresses 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 earlier requirements.

### Examination-Frequency Guidelines

In August 1998, the Federal Reserve and the other federal banking agencies issued an interim rule revising 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 U.S. branches and agencies of foreign banking organizations may qualify for an eighteen-month examination cycle rather than a twelve-month cycle.

To qualify for consideration for less-frequent examination, a U.S. branch or agency must have total assets of \$250 million or less, must have received a composite supervisory rating of 1 or 2 at its most recent examination, and must not be subject to a formal enforcement action. In addition, the U.S. branch or agency must have satisfied the requirements that either (1) the foreign bank's most recently reported capital adequacy position consists of, or is equivalent to, tier 1 and total risk-based capital ratios of at least 6 percent and 10 percent respectively, on a consolidated basis; or (2) the office has maintained, on a daily basis over the past three quarters, eligible assets (determined consistent with applicable federal and state law) in an amount not less than 108 percent of the preceding quarter's average third-party liabilities and sufficient liquidity is currently available to meet its obligations to third parties. Finally, the foreign bank must not have experienced a change in control during the preceding twelve months.

### Guidance on Credit Risk Management

During 1998, the Federal Reserve issued guidance regarding the internal rating systems banks use to support their sophisticated credit risk management systems. The guidance underlines the need for supervisors and examiners, both in their on-site examinations and inspections and in their other contacts with banking organizations, to emphasize the importance of developing and implementing effective internal credit-rating systems and the critical role

such systems should play in the credit risk management process at sound large institutions. The study on which this guidance is based is available in the November 1998 *Federal Reserve Bulletin* and on the Federal Reserve's public web site.

Also in 1998, the Federal Reserve undertook an extensive study of lending terms and standards. This study, involving several hundred loans from across the country and many of the Federal Reserve's most experienced examiners, compared loans made in late 1995 with loans made in late 1997. The study concluded that intense competition for loan customers had led to a significant easing of pricing and of some non-price terms but that, on balance, the overall quality of loans being made had not changed significantly over the period, largely because of favorable economic conditions.

### Risk Assessment of an Institution's Information Technology

In April 1998, the Federal Reserve issued guidance on assessing information technology in the risk-focused frameworks for the supervision of community banks and large, complex banking organizations. The guidance highlights the critical dependence of the financial services industry on information technology, reinforces the concept that the risk-focused supervisory process must address the risks associated with the use of information technology, and provides a basic framework and a common vocabulary for evaluating the effectiveness of processes used to manage the risks associated with information technology.

### Bank Holding Company Reports

As the federal supervisor and regulator of all U.S. bank holding companies, the

Federal Reserve requires periodic regulatory reports from these organizations. These reports provide essential information to assist the Federal Reserve in the formulation of regulations and supervisory policies. The reports are also used by the Federal Reserve to respond to requests from the Congress and the public for information on bank holding companies and their nonbank subsidiaries. The FR Y-9 series of reports (FR Y-9C, FR Y-9LP, and FR Y-9SP) provides standardized financial statements for the consolidated bank holding company and its parent. The Federal Reserve uses these reports to detect emerging financial problems, to review performance and conduct pre-inspection analysis, to monitor and evaluate risk profiles and capital adequacy, to evaluate proposals for bank holding company mergers and acquisitions, and to analyze a bank holding company's overall financial condition to ensure safe and sound operations. The FR Y-11 series of reports aids the Federal Reserve in determining the condition of bank holding companies that are engaged in nonbanking activities and in monitoring the volume, nature, and condition of their nonbanking subsidiaries.

During 1998, revisions that reduce reporting burden were made to the FR Y-9C; the revisions generally conform with revisions to the FFIEC 031 Call Report, including the elimination of several detailed items on investment securities and trading portfolios and the addition of items to monitor compliance with risk-based capital standards for market risk exposures and for low-level recourse transactions.<sup>3</sup> Revisions to the

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3. Revisions to the Call Reports are discussed later in this section in connection with the work of Federal Reserve staff under the auspices of the Federal Financial Institutions Examination Council (FFIEC).

FR Y-9LP and FR Y-9SP during 1998 were minor and consisted mainly of the addition of items to collect information about nonbank subsidiaries of bank holding companies. There were no substantive revisions to the FR Y-11 series of reports during the year.

In December 1998, the Federal Reserve announced proposed revisions to the FR Y-9 and FR Y-11 series of reports effective with the March 1999 reporting date. Most of the proposed revisions pertain to the FR Y-9C and attempt to minimize reporting burden by generally paralleling proposed revisions to the FFIEC 031 Call Report. The proposed revisions to the FR Y-9C include the elimination of detailed items for high-risk mortgage securities; implementation of the disclosure requirements of Statement of Financial Accounting Standard (FAS) No. 133, Accounting for Derivative Instruments and Hedging Activities, for cash flow hedges; and implementation of items for monitoring risk-based capital. The proposed revisions to the other FR Y-9 reports and to the FR Y-11 series of reports consist primarily of implementation of the FAS 133 disclosure requirements for cash flow hedges. The addition of a section for "Notes to the Financial Statements" has also been proposed for the FR Y-11 series.

## Federal Financial Institutions Examination Council

### *Year 2000 Supervision Program*

The Federal Reserve has worked closely with the other federal banking agencies to address the banking industry's readiness for the Year 2000. Under the auspices of the Federal Financial Institutions Examination Council, the Federal Reserve and the other member agencies

continued in 1998 to assess the readiness of financial institutions, service providers, and software vendors to ensure that Year 2000-related computer problems and major service disruptions to customers and the banking system do not occur. The review program is divided into three phases and emphasizes five components of preparedness. Phase 1 (June 1997 through June 1998) focused on evaluating an institution's ability to understand the myriad issues related to Year 2000 (the Awareness and Assessment components) and its progress in identifying necessary changes to its computer programs to ensure their correct operation during the century date change and beyond. During phase 2 (July 1998 through March 1999), examiners are assessing institutions' progress toward making, and then testing, the necessary changes to their computer programs and systems (the Renovation and Validation components). Phase 3 (beginning in April 1999 and continuing into 2000) will concentrate on assessing the adequacy of the final stages of testing and contingency planning efforts (the Implementation component).

As part of their efforts, the agencies in 1998 issued a series of guidance statements on important aspects of Year 2000, including

- Guidance Concerning Institution Due Diligence in Connection with Service Provider and Software Vendor Year 2000 Readiness (March 17)
- Guidance Concerning the Year 2000 Impact on Customers (March 17)
- Guidance Concerning Testing for Year 2000 Readiness (April 10)
- Guidance on Year 2000 Customer Awareness Programs (May 13)
- Guidance Concerning Contingency Planning in Connection with Year 2000 Readiness (May 13)

- Questions and Answers Concerning FFIEC Year 2000 Policy (August 31)
- Guidance Concerning Fiduciary Services and Year 2000 Readiness (September 2)
- Interagency Guidelines Establishing Year 2000 Standards for Safety and Soundness (October 15)
- Questions and Answers Concerning Year 2000 Contingency Planning (December 11).

To help institutions understand the Year 2000 guidance statements and review process, the agencies conducted hundreds of banker and community outreach programs throughout the country. The programs focused on supervisory expectations and served to convey a consistent message.

Finally, the member agencies of the FFIEC participated in the President's Council on Year 2000 Conversion, which is coordinating the federal government's efforts to address the Year 2000 problem. The council is made up of representatives of more than thirty major federal executive and regulatory agencies. Some agencies serve as sector coordinators to promote action on the Year 2000 problem within their policy areas. The Federal Reserve Board is the coordinator for the working group on the finance sector, which comprises representatives of twenty-one organizations involved in the financial services industry. This broad-based group has been instrumental in furthering the goals of the agencies and is making every effort to ensure that financial institutions are prepared for the century date change.

*Policy Statement on  
Investment Securities and  
End-User Derivatives Activities*

On April 23, 1998, the FFIEC issued a Supervisory Policy Statement on Investment Securities and End-User Deriva-

tives Activities (referred to as the 1998 Policy Statement). The policy statement, which was adopted by the Federal Reserve, provides guidance on sound practices for managing the risks involved in investment and end-user activities. It rescinded the constraints on investments in "high risk" mortgage derivatives products contained in the 1992 FFIEC Supervisory Policy Statement on Securities Activities.

The guidance in the 1998 Policy Statement reflects the agencies' move to a more risk-focused approach to supervision. This approach considers the appropriateness of an instrument held for investment or end-user purposes in light of a several factors, including management's ability to measure and manage the risks of the institution's holdings and the effect of those holdings on aggregate portfolio risk. The statement reflects a supervisory focus on evaluating and controlling risks on an investment-portfolio or an institution-wide basis.

*Uniform Rating System for  
Information Technology*

On December 18, 1998, the FFIEC Task Force on Supervision revised the Uniform Interagency Rating System for Data Processing Operations, commonly referred to as the Information Systems rating system. The revised system, whose formal name was changed to the Uniform Rating System for Information Technology (URSIT), reflects changes in the data-processing-services industry and in supervisory policies and procedures since the rating system was first adopted in 1978. In the new system, the numerical ratings have been revised to conform to the language and tone of the ratings definitions used in the Uniform Financial Institutions Rating System, commonly referred to as the CAMELS

rating system. Also, the component rating descriptions have been reformatted and clarified, and the quality of risk-management processes is emphasized in the descriptions of the rating components. In addition, two new component categories—Development and Acquisition, and Support and Delivery—have replaced two former categories (Systems Development and Programming, and Operations). Finally, the new system explicitly identifies the types of risk that are considered in assigning component ratings.

#### *Uniform Interagency Trust Rating System*

On October 13, 1998, the FFIEC adopted revisions to update the Uniform Interagency Trust Rating System (UITRS), which became effective for examinations beginning on or after January 1, 1999. The UITRS is a supervisory rating system, originally adopted in 1978, used to promote consistency among the federal banking agencies in evaluating the fiduciary activities of institutions under their supervisory jurisdiction. The Federal Reserve issued implementing guidelines for the revised UITRS for Federal Reserve examiners in December 1998.

The major revisions to the UITRS included (1) modifying the definitions of the ratings to better align the UITRS rating definitions with the language and tone of the CAMELS and BOPEC ratings, (2) combining the Account Administration and Conflict of Interest rating components into a new Compliance component, (3) requiring a rating of Earnings only for those institutions that are required to file schedule E of the FFIEC 001 report (those with trust assets of more than \$100 million), and (4) placing greater emphasis on risk-management processes.

#### *Revisions to Call Reports*

The FFIEC implemented changes to the bank Reports of Condition and Income (Call Reports), effective with the March 1998 report, to improve the banking agencies' ability to monitor compliance with certain regulations and to eliminate items that were considered unnecessary for safety and soundness or for other public policy purposes. The changes enable the agencies to more readily monitor compliance with the risk-based capital standards for market risk exposures and low-level recourse transactions and also reduce the burden of reporting certain information on deposits, investment securities, and trading portfolios. 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 1998 report, to maintain consistency with the bank Call Reports.

In October, the Federal Reserve and the other federal banking agencies proposed a small number of revisions to the bank Call Reports to facilitate bank supervision. The revisions would, effective with the March 1999 report, add items to conform with changes in GAAP, specifically the disclosure requirements of Statement of Financial Accounting Standard No. 133, Accounting for Derivative Instruments and Hedging Activities. The revisions would also eliminate several detailed items on bank investment portfolios and certain agricultural loan information.

In November, the Federal Reserve and the other federal banking agencies announced the discontinuation of the Monthly Consolidated Foreign Currency Report of Banks in the United States (FFIEC 035), effective with the December 1998 report. The agencies determined that the foreign exchange activities reported in the FFIEC 035 could

be monitored through other supervisory means. Some of the information once collected through the report will be collected by the Department of the Treasury.

### **Supervisory Information Technology**

The Supervisory Information Technology (SIT) function was established within the Board's Division of Banking Supervision and Regulation to facilitate management of the diverse information technology (IT) requirements of the Federal Reserve's supervision function. Its goals are to ensure that

- IT initiatives support a broad range of supervisory activities without duplication or overlap
- The underlying IT architecture fully supports those initiatives
- The supervision function's use of technology takes advantage of the systems and expertise available more broadly within the Federal Reserve System.

The SIT function works through assigned staff at the Board of Governors and at selected Reserve Banks and through a committee structure that ensures that key staff members actively participate in identifying requirements and setting priorities for IT initiatives.

### **Large Bank Supervision**

During 1998, significant progress was made in developing a new information system to support the supervision of large, complex banking organizations. The system, scheduled for implementation in September 1999, will provide collaboration, messaging, and document-management capabilities.

### **Community Bank Supervision**

For the past three years, the Federal Reserve has worked closely with the FDIC, the Conference of State Bank Supervisors, and several state banking authorities to automate the examination process for community banks. The agencies now have a set of automated examination tools that support a common supervisory approach. The FDIC and several states began using the first version of one of these tools in the fourth quarter 1998. The Federal Reserve will begin implementing this same tool in the second quarter of 1999.

### **Document Management**

The Federal Reserve is developing a document repository using a commercial document-management software system. The repository, which will be part of the Federal Reserve's National Information Center (NIC), will initially contain all examination-related documents that result from the large, complex banking organization supervision program. Examination documents from the community bank supervision program will immediately follow. Other supervisory documents will be added to the repository as requirements are defined.

### **National Information Center**

During the past year, the Federal Reserve further expanded the capabilities of the NIC. In January, the National Examination Data (NED) system was fully implemented. NED uses state-of-the-art client/server technology to provide on-line access to NIC banking structure, financial, and examination data. NIC is accessible by supervision staff across the Federal Reserve System over the System's intranet. Since

November, NIC has been accessible by state banking authorities and the other federal regulators that use the NED system over an extranet developed by the Federal Reserve.

In March, the first version of a new banking structure updating system was implemented as part of NIC. When the second version is complete, NIC will have a new automation architecture that provides for state-of-the-art client/server and web technologies such that NIC can be accessed easily and can be modified quickly to respond to changing demands in the financial services industry.

Finally, the capabilities of the NIC public web site have been expanded.

The site (<http://www.ffiec.gov/nic/>) contains all NIC banking structure and financial data and, since November 1998, all bank holding company performance ratios.

**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,

Number of Sessions of Training Programs for Banking Supervision and Regulation, 1998

Program	Total	Regional
<i>Schools or seminars conducted by the Federal Reserve</i>		
<i>Core schools</i>		
Introduction to examinations <sup>1</sup> .....	5	3
Banking and supervision elements .....	3	2
Financial institution analysis .....	9	6
Bank management .....	5	3
Effective writing for banking supervision staff <sup>2</sup> .....	12	12
Report writing .....	3	3
Management skills .....	10	9
Conducting meetings with management .....	16	16
<i>Other schools</i>		
Loan analysis .....	6	5
Real estate lending seminar .....	4	1
Specialized lending seminar .....	4	4
Senior forum for current banking and regulatory issues .....	3	3
Banking applications .....	1	..
Bank holding company inspections .....	5	4
Basic entry-level trust .....	1	..
Advanced trust .....	1	..
Consumer compliance examinations I .....	2	..
Consumer compliance examinations II .....	2	1
CRA examination techniques .....	3	1
Fair lending .....	5	1
Foreign banking organizations .....	3	2
Information systems and emerging technology risk management .....	18	18
Information systems continuing education .....	3	..
Intermediate information systems examination .....	1	..
Capital markets seminars .....	24	18
Section 20 securities seminar .....	2	..
Internal controls .....	6	5
Seminar for senior supervisors of foreign central banks <sup>3</sup> .....	1	..
<i>Other agencies conducting courses<sup>4</sup></i>		
Federal Financial Institutions Examination Council .....	43	4
Office of the Comptroller of the Currency .....	2	..

NOTE. . . . Not applicable.  
 1. Replaced by Banking and Supervision Elements in September.

2. Replaced by Report Writing in August.  
 3. Conducted jointly with the World Bank.  
 4. Open to Federal Reserve employees.

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 other regulators of 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 Federal Reserve System also participates in training offered by the Federal Financial Institutions Examination Council 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.

During 1998, the Federal Reserve conducted a variety of schools and seminars, and staff members participated in several courses offered by or cosponsored with other agencies, as shown in the accompanying table. In 1998, the

Federal Reserve trained 3,502 students in System schools, 822 in schools sponsored by the FFIEC, and 75 in other schools, for a total of 4,399, including 322 representatives from foreign central banks. The number of student days of training was 36,790, which was 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 789 state examiners were trained: 504 in Federal Reserve courses, 277 in FFIEC programs, and 8 in other courses.

Every staff member seeking an examiner's commission is required to pass proficiency examinations, which include a core content area and a specialty area of the student's choice—safety and soundness, consumer affairs, trust, or information technology. In 1998, 96 students took the examination (see table).

The System continued in 1998 to make revisions initiated in 1997 to the 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

Status of Students Registered for the Core Proficiency Examination, 1998

Student status	Core	Specialty area			
		Safety and soundness	Consumer	Trust	Information technology
In queue, year-end 1997 .....	23	13	9	0	1
Test taken, 1998 .....	96	63	34	3	2
Passed .....	83	53	28	2	2
Failed .....	13	10	6	1	0
In queue, year-end 1998 .....	33	22	10	1	0

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

applies to banking, and the key supervisory issues related to integrated supervision. The changes will be implemented over 1999.

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

The Federal Reserve 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 company 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 1998, the Federal Reserve approved 310 proposals by foreign or domestic companies to become bank holding companies; approved 177 proposals by existing bank holding companies to merge with other bank holding companies; approved 319 proposals by existing bank holding companies to acquire or retain banks; approved 490 requests by existing bank holding companies to acquire nonbank firms engaged in activities closely related to banking; and approved 201 other bank holding company applications or notices. 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 1998, the Federal Reserve approved 162 merger applications. As required by law, each merger is described in this REPORT (in table 15 of the "Statistical Tables" section).

When the FDIC, the OCC, or the OTS has jurisdiction over a proposed 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 844 reports on competitive factors to the other federal banking agencies in 1998.

### Change in Bank Control Act

The Change in Bank Control Act requires that persons seeking control of a U.S. bank or bank holding company 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 adverse effect on the federal deposit

Decisions by the Federal Reserve, Domestic and International Applications, 1998

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 bank holding company .....	13	0	0	0	0	5	210	82	310
Merger of bank holding company .....	16	0	0	0	0	23	91	47	177
Acquisition or retention of bank .....	32	0	0	0	0	29	182	76	319
Acquisition of nonbank .....	3	0	132	0	0	62	2	291	490
Merger of bank .....	15	0	0	0	0	14	133	0	162
Change in control .....	2	0	0	0	0	0	0	165	167
Establishment of a branch, agency, or representative office by a foreign bank .....	22	0	1	0	0	0	0	1	24
Other .....	239	0	34	28	0	387	1,177	148	2,013
<b>Total .....</b>	<b>342</b>	<b>0</b>	<b>167</b>	<b>28</b>	<b>0</b>	<b>520</b>	<b>1,795</b>	<b>810</b>	<b>3,662</b>

insurance funds. For certain proposals, the notice process may involve conducting name checks with other agencies of the U.S. government.

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. In 1998, the Federal Reserve acted on 167 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 condition and 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. 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.

In 1998, the Federal Reserve approved applications by nine foreign banks from seven foreign countries to establish branches, agencies, and representative offices in the United States.

### Public Notice of Federal Reserve Decisions

Most decisions by the Federal Reserve that involve 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, as are all applications and notices that have been received by the Federal Reserve but not yet acted on. Each of these matters is subsequently reported in the Board's weekly H.2 statistical release (Actions of the Board, Its Staff, and the Federal Reserve Banks; Applications and Reports Received) and in the monthly *Federal Reserve Bulletin*. The related H.2A release (Notice of Formations and Mergers of, and Acquisitions by, Bank Holding Companies; Change in Bank Control) contains the ending comment periods for each pending application and notice. In 1998, the Board's public web site was enhanced to include not only the H.2 and the H.2A, but also other information relevant to the applications process.

### 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 final action ranges from twelve to sixty days, depending on the type of application or notice. In 1998, 93 percent of decisions met these deadlines.

### 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 Division of Banking Supervision and Regulation, and to the Secretary of the Board. In 1998, 86 percent of the applications processed were acted on under delegated authority.

### Banking and Nonbanking Proposals

Consolidation among some of the largest U.S. banking organizations continued in 1998. The Federal Reserve approved five proposals for which public meetings were held in cities throughout the United States; as in earlier cases, the proposals generated many comments, particularly with respect to Community Reinvestment Act, fair lending, and competitive issues. The Federal Reserve also approved various proposals involving mutual bank holding companies. In 1998, the Federal Reserve continued to act on proposals involving section 20 companies. The proposals involved expansion on a de novo as well as acquisition basis. Early in the year, the Board also streamlined the restrictions applicable to bank holding companies that seek to act as a commodity pool operator or otherwise to act as a general partner of an investment fund.

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

U.S. banking organizations, with the authorization of the Federal Reserve, 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 1998, the Board approved thirty-eight proposals (excluding those related to recent large domestic mergers) by U.S. banking organizations to make significant investments overseas.

The Federal Reserve 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 1998, the Board approved two proposals by member banks to increase their investment in their Edge corporation subsidiaries to more than 10 percent but less than 20 percent of the member bank's capital and surplus. The Board also approved four applications for the establishment of new agreement corporations.

### Applications by Member Banks

State member banks must obtain Board approval to establish domestic branches, and all 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 1998, the Federal Reserve acted on new and merger-related branch proposals related to 1,473 domestic branches and granted prior approval for the establishment of 13 foreign branches (excluding those related to recent large domestic mergers).

### **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 bank holding companies that fail to meet certain standards, including the Board's capital guidelines. In 1998, the Federal Reserve reviewed twenty-nine proposed stock repurchases by bank holding companies, all of which were approved under delegated authority by either a Reserve Bank or the Secretary of the Board.

### **Recent Regulatory Changes**

In July 1998, the Board approved various amendments to Regulation H, which implements the Federal Reserve Act, portions of the Federal Deposit Insurance Act, and related statutes. The amendments were designed to reduce regulatory burden and to simplify and update the regulation. As part of the final regulation, the Board adopted new expedited procedures for membership and branch applications, modified various criteria related to membership in the

Federal Reserve System, and provided further guidance to member banks regarding permissible investments in securities. The Board also adopted new definitions for various terms used in the regulation, including those related to capital stock and surplus and to a branch.

### **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 1998, twenty-five state member banks, most of them small or medium sized, were registered with the Board under the Securities Exchange Act.

#### **Securities Credit**

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's Regulation T limits the amount of credit that may be provided by securities brokers and dealers. The Board's Regulation U, which had limited the amount of credit that may be provided by commercial banks, was amended effective April 1998 to also cover lenders other than banks, brokers, or dealers. Lenders other than banks, brokers, or dealers were formerly subject to Regulation G, which was eliminated in April 1998. The Board's

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 Securities and Exchange Commission, 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 Farm Credit Administration, the National Credit Union Administration, and the Office of Thrift Supervision examine lenders under their respective jurisdictions; and the Federal Reserve examines any other lenders.

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. Regulation U limits the amount of credit that lenders other than brokers and dealers may extend when the credit is used to purchase or carry publicly held equity securities if the loan is secured by those or other publicly held equity securities.

Since 1968, the Federal Reserve has monitored the market activity of all stocks traded over-the-counter (OTC) in the United States to determine which of them are subject to the Board's margin regulations. Also since that time, the Board has periodically published the resulting "List of Marginable OTC Stocks." In 1997, the Board amended its margin regulations to eliminate the OTC list by the end of 1998 and instead to rely on the listing standards of the Nasdaq Stock Market. The Board published the last OTC list in November 1998. It also published OTC lists in February, May, and August 1998.

Since 1990, the Board has published a list of foreign stocks that are eligible for margin treatment at broker-dealers on the same basis as domestic margin securities. In 1998, the foreign list was revised in February, May, August, and November.

### **Bank Secrecy Act/Anti-Money Laundering**

The regulation (31 CFR Part 103) implementing the Currency and Foreign Transactions Reporting Act, also known as the Bank Secrecy Act, requires banks and other types of financial institutions to file certain reports and to maintain certain records. The requirements include the reporting of information concerning persons involved in large currency transactions as well as suspicious activity related to a possible violation of federal law. Records that must be maintained include those kept in the ordinary course of business as well as the identity of persons who purchase monetary instruments with currency and those who send or receive funds transfers in substantive amounts. The act is regarded as a primary tool in the fight against money laundering; in part it creates a paper trail that helps law enforcement agencies and regulators identify and trace the proceeds of illegal activity.

Pursuant to Regulation H, section 208.63, each banking organization supervised by the Federal Reserve must also develop a program for compliance with the Bank Secrecy Act. The program, which must be in writing and formally approved by the institution's board of directors, must (1) establish a system of internal controls to ensure compliance with the act, (2) provide for independent compliance testing, (3) identify individual(s) responsible for coordinating and monitoring day-to-day compliance, and (4) provide training

for appropriate personnel. Through its examination process, training, and other off-site measures, the Federal Reserve monitors compliance with the Bank Secrecy Act and Regulation H by the banking organizations under its supervision.

In 1998, the Federal Reserve continued 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 burdens created by the act's requirements and to increase the utility of data collected under the act to regulators and law enforcement agencies. In October, in consultation with and assistance from the Federal Reserve, the Treasury Department issued final rules revising exemption procedures to reduce significantly the number of Currency Transaction Reports filed. The Federal Reserve also led an interagency group that revised the Suspicious Activity Report to make it more useful to law enforcement as well as Year 2000 compliant. The new form is scheduled for use in the spring of 1999.

The Federal Reserve in December issued a proposed rule regarding Know Your Customer programs. The proposal was issued along with nearly identical proposals by the Office of the Comptroller of the Currency, the Federal Deposit

Insurance Corporation, and the Office of Thrift Supervision.

Through the Special Investigations Section of the Division of Banking Supervision and Regulation, the Federal Reserve in 1998 assisted in the investigation of money laundering activities, including Operation Casablanca, which involved a number of foreign banking organizations. The section also provided anti-money-laundering training to designated staff members at each Reserve Bank, to the domestic banking sector through trade association conferences and seminars, and to representatives of law enforcement agencies.

Internationally, the section assisted the State Department by providing anti-money-laundering training and technical assistance to countries in Asia, eastern Europe and the newly independent states, South and Central America, and the Caribbean. Board staff also participated extensively in numerous multilateral international anti-money-laundering initiatives including the G-7, the Financial Action Task Force, and the Asia Pacific Working Group on Money Laundering.

### Loans to Executive Officers

Under section 22(g) of the Federal Reserve Act, a state member bank must include in its quarterly Call Report

Loans by State Member Banks to their Executive Officers, 1997 and 1998

Period	Number	Amount (dollars)	Range of interest rates charged (percent)
<i>1997</i>			
October 1–December 31 .....	695	38,279,000	4.8–20.0
<i>1998</i>			
January 1–March 31 .....	750	42,592,000	3.0–19.5
April 1–June 30 .....	750	37,183,000	3.0–18.0
July 1–September 30 .....	657	34,564,000	2.0–19.5

SOURCE. Call Reports.

information on all extensions of credit by the bank to its executive officers since the date of the preceding report. The accompanying table summarizes this information.

System. At that time, member banks were operating 46,112 branches and additional offices and accounted for 39 percent of all commercial banks in the United States and for 74 percent of all commercial banking offices. ■

### **Federal Reserve Membership**

At the end of 1998, 3,401 banks were members of the Federal Reserve