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Bank and Nonbank Competition for Small Business Credit: Evidence from the 1987 and 1993 National Surveys of Small Business Finances

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Table of Contents

Bank and Nonbank Competition for Small Business Credit: Evidence from the 1987 and 1993 National Surveys of Small Business Finances

Rebel A. Cole and John D. Wolken, of the Board's Division of Research and Statistics, and R. Louise Woodburn, of the Internal Revenue Service, prepared this article. Amy Ashton and Ronnie McWilliams provided research assistance.

Using newly available data from the Board's 1993 National Survey of Small Business Finances together with data from the 1987 survey, we analyze competition between banks and nonbanks in the U.S. market for small business credit. According to many academics and banking practitioners, the U.S. commercial banking industry has declined.[1] In particular, during the late 1980s and the early 1990s, the record number of bank failures and mergers reduced the number of commercial banks in the United States. Also, there has been an apparent decline in commercial banks' share of lending. These occurrences have raised questions about the changing role of commercial banks in providing credit to key sectors, including business lending.

Several explanations have been advanced for the decline in banks' share of business lending. In particular, technological changes in communications, information storage, and other sectors of the economy—as well as globalization—have enabled an increasing number of large firms to gain direct access to money and capital markets. The same technological changes have facilitated competition from nonbank sources. Nonbanks consist of thrift institutions (savings and loan associations, savings banks, and credit unions), finance companies, insurance companies, mortgage companies, leasing companies, brokerage firms, other business firms, families and individuals, and government sources of credit.

We explore nonbank competition as an explanation for the decline in banks' share of business lending by examining sources of credit used by small firms.[2] Credit here is defined as loans and capital leases, excluding credit card debt and trade credit. Because small firms are unlikely to have direct access to money and capital markets, any decline in banks' share of the aggregate dollar amount of credit provided to these firms would be consistent with the view that nonbanks are eroding this share. If banks have provided a constant or increasing share of the credit used by small firms, such evidence would run counter to the view that nonbanks are eroding this share.

We analyze the bank and nonbank shares of the dollar amount of outstanding credit to small businesses, including how these shares have changed from 1987 to 1993. We also examine the incidence of small business borrowing from banks and nonbanks, which is defined as the percentage of firms using credit of a certain type or from a particular source. The incidence data provide a more representative view of the credit services used by a "typical" small firm than do the share data because larger firms have a greater influence on market shares than on incidence. This distinction is important because the larger firms in the survey account for the majority of the dollar amount outstanding of small business credit

NOTE. Ms. Woodburn is on detail to the Board's Division of Research and Statistics as a sampling statistician.

1. See, for example, Allen N. Berger, Anil K. Kashyap, and Joseph M. Scalise, "The Transformation of the U.S. Banking Industry: What a Long, Strange Trip It's Been," *Brookings Papers on Economic Activity*, *1:1995*, pp. 55–218; John H. Boyd and Mark Gertler, "Are Banks Dead? Or, Are the Reports Greatly Exaggerated?" Federal Reserve Bank of Minneapolis, *Quarterly Review* (Summer 1994), pp. 2–23; Franklin R. Edwards and Frederic S. Mishkin, *The Decline of Traditional Banking: Implications for Financial Stability and Regulatory Policy*, Working Paper 4993 (National Bureau of Economic Research, January 1995); Edward C. Ettin, "The Evolution of the North American Banking System" (paper prepared for the Experts' Meeting on Structural Changes in Financial Markets: Trends and Practices, Organization for Economic Cooperation and Development, Paris, July 11–12, 1994); and Gary Gorton and Richard Rosen, "Corporate Control, Portfolio Choice, and the Decline of Banking," *Journal of Finance*, vol. 50 (December 1995), pp. 1377–1420.

2. More specifically, the results presented in this paper characterize all enterprises operating under current ownership during 1992 and with fewer than 500 full-time-equivalent employees, excluding real estate operators and lessors, real estate subdividers and developers, real estate investment trusts, agricultural enterprises, financial institutions, not-for-profit institutions, government entities, and subsidiaries controlled by other corporations. Full-time-equivalent employment is calculated as the number of full-time employees plus one-half the number of part-time employees.

but for only a small proportion of the number of firms. For example, among small businesses, firms with more than $1 million in sales account for more than two-thirds of credit but less than one-fifth of the number of firms.

The sources for these data—the 1987 and 1993 National Surveys of Small Business Finances (NSSBF)—are unique.[3] The NSSBF is a nationally representative survey of small businesses sponsored by the Federal Reserve Board and the U.S. Small Business Administration to collect information about the sources and types of financial services obtained by small businesses. The surveys are designed to be representative of small businesses generally and provide data on bank and nonbank shares of the small business credit market.[4] The NSSBF was conducted first in 1987 and again in 1993, making it possible to examine changes in market share over that period. Although the two surveys had somewhat different focuses, the data collected are sufficiently similar to allow comparisons of bank and nonbank market shares across time.[5] However, differences in the coverage of the two surveys preclude comparisons of actual dollar amounts. Hence, this analysis cannot address whether total lending to small businesses rose or fell over the period.

This article provides background information about macroeconomic changes that could be expected to have influenced credit conditions over 1987–93, reviews the types of credit supplied to small businesses by banks and nonbanks, and tests whether banks have lost market share to nonbanks. We use two different measures of market share—the percentage of the aggregate dollar amount of credit used by small businesses and the percentage of small businesses using credit.

Overall, our results indicate that small businesses obtained a higher percentage of their credit from nonbanks in 1993 than in 1987 but that this difference was small—about 2.0 percentage points. Banks still provided more than 60 percent of the dollar value of credit, excluding trade credit and credit card debt, and dominated in the provision of credit lines used. However, the percentage of firms obtaining credit from banks dropped significantly, from 44.0 percent in 1987 to only 36.8 percent in 1993, whereas the percentage of firms obtaining credit from nonbanks was stable at 32 percent.[6]

Within the general category of nonbanks, the data indicate that thrift institutions have lost about half of their dollar share, which fell from 7.4 percent to 4.0 percent, of the small business credit market over 1987–93. The losses of market share by banks and thrift institutions primarily accrued to finance companies, leasing companies, and brokerage firms.

The surveys provide information about the different types of loans and various demographic characteristics of small businesses. Overall, mortgages have become a much smaller share of small business debt, while borrowings under lines of credit became a larger share between 1987 and 1993. The percentage of small businesses that used credit lines, equipment loans, and capital leases rose significantly, while the percentage that used mortgages declined significantly. During this period, banks lost market share disproportionately at medium-sized small businesses and at minority-owned firms.

While the evidence presented here suggests that nonbanks have somewhat eroded banks' share of small business credit, it does not address bank and nonbank competition in the provision of other financial services used by small businesses, the most prominent being checking and savings accounts.

3. At the time this article was written, the 1993 NSSBF data were still in the editing stage and hence subject to revision. After data edits and other processing steps are completed, an announcement about the availability of the 1993 survey data and a user's manual will appear in the *Federal Reserve Bulletin*.

4. For information about alternative sources of data on small businesses, see U.S. Small Business Administration, *Handbook of Small Business Data*, 2d ed. (Government Printing Office, 1994), and *The State of Small Business: A Report of the President, 1995* (Government Printing Office, 1996).

Bank and thrift regulators began in 1993 to collect data on the aggregate number and amount of small commercial loans outstanding (loans of less than $1,000,000) at financial institutions, but these data cannot be used to estimate the shares of bank and nonbank lending. They reflect loans made by depository institutions but not loans made by nondepository sources such as brokerage, finance, insurance, and leasing companies.

Surveys of small businesses conducted by trade organizations such as the National Federation of Independent Businesses generally collect information on the incidence of use. Information on dollar amounts by source and loan type are rarely available. See also a 1996 survey conducted for the *American Banker* by Payment Systems, Inc. (''Credit Lines, Leasing in Demand as Small Businesses' Needs Evolve,'' *American Banker*, September 9, 1996, pp. 9–11).

5. The 1993 NSSBF focused on the availability of credit to small and minority-owned businesses, and the 1987 survey focused on the definition of banking markets. Both surveys, however, collected a complete roster of the credit lines, loans, and leases obtained by each firm surveyed, including information on the amount of credit obtained and the identity of the lender. Because of broad changes in the coverage of the two surveys, valid comparisons between 1987 and 1993 data can be made only after statistical adjustments to sampling weights have been made to make them more comparable. See the appendix for a description of these weighting adjustments. For more information about the 1993 NSSBF, see Rebel A. Cole and John D. Wolken, ''Financial Services Used by Small Businesses: Evidence from the 1993 National Survey of Small Business Finances,'' *Federal Reserve Bulletin*, vol. 81 (July 1995), pp. 629–67. For more information about the 1987 NSSBF, see Gregory E. Elliehausen and John D. Wolken, ''Banking Markets and the Use of Financial Services By Small and Medium-Sized Businesses,'' *Federal Reserve Bulletin*, vol. 76 (October 1990), pp. 801–17.

6. Tests of statistical significance are computed for the change statistics as discussed in the appendix.

Indeed, 87.8 percent of small businesses used commercial banks for financial services during 1993, more than double the percentage of such firms using nonbanks.[7] Whether banks have gained or lost ground to nonbanks in the provision of noncredit financial services is an interesting topic for future analysis using data from the NSSBF.

BACKGROUND

The 1980s and early 1990s were periods of tumultuous change for the U.S. commercial banking industry. First, two major banking laws, the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn–St Germain Depository Institutions Act of 1982, removed numerous regulations that limited competition among banks and between banks and nonbanks. For example, interest rate ceilings were phased out, and many restrictions on how much banks and thrift institutions could invest in particular asset classes were eased. Additional legislation at the state level eased or removed many limitations on geographic expansion by banks.[8] Subsequently, a sequence of economic shocks in the 1980s from the collapse of agricultural, oil, and commercial real estate prices contributed to losses that caused banks to fail in numbers not seen since the Great Depression, even though the economy was in an expansion that lasted from 1982 to 1990. More than 100 banks failed in each year from 1985 to 1992, and more than 200 failed each year in 1987, 1988, and 1989. Presumably, these failures tended to eliminate less-efficient banks, whose assets were transferred to more-efficient competitors, thereby leaving a banking industry better equipped to compete with nonbanks.[9]

Following deregulation, the banking industry consolidated sharply via nearly 3,000 mergers during the 1987–93 period. These mergers reduced the ranks of small banks, which tend to specialize in small business lending, as larger banks acquired their smaller competitors. About two-thirds of the acquired banks held less than $100 million in assets, while roughly half of the acquirers held more than $1 billion in assets. The percentage of industry assets at the largest banks, those with assets of more than $100 billion, grew from 12.7 percent at the end of 1986 to 24.1 percent at the end of 1993. Together, bank failures and mergers caused the number of chartered U.S. commercial banks to decline almost one-fourth during the 1987–93 period, from 14,210 to 10,960. During the same period, however, banking industry assets grew from $2.94 billion to $3.71 billion.

The 1987–93 period also saw record numbers of failures by nonbank competitors, primarily savings and loan associations and savings banks; because of failures and mergers, these institutions declined by almost half during the period, from 3,677 to 2,262. Unlike banking assets, which rose over this period of consolidation, the assets of savings and loans and savings banks fell, from $1.39 trillion to $1.0 trillion. Contributing to this divergent experience was the acquisition of the savings institutions' assets by commercial banks.

Largely in response to the record numbers of depository failures and the urging of bank and thrift regulators, the Congress passed two more major banking laws, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Together, FIRREA and FDICIA ushered in regulations regarding risk-based capital and prompt corrective action that effectively increased capital requirements for large portions of the banking and thrift industries.

At the same time, the overall weakness of economic activity left many businesses unwilling to take on new debt and, in many cases, unable to service their existing debt. Their plight contributed to record loan losses in the banking industry. Especially hard hit was the market for commercial mortgages, where prices, as measured by the Russell NCREIF Property Index, dropped almost one-third during the 1990–92 period.

The brief recession of 1990–91 included a slowing of credit flows that numerous economic observers characterized as a ''credit crunch.'' Whether the more stringent banking regulations and the supply of bank credit played a role in bringing about these conditions

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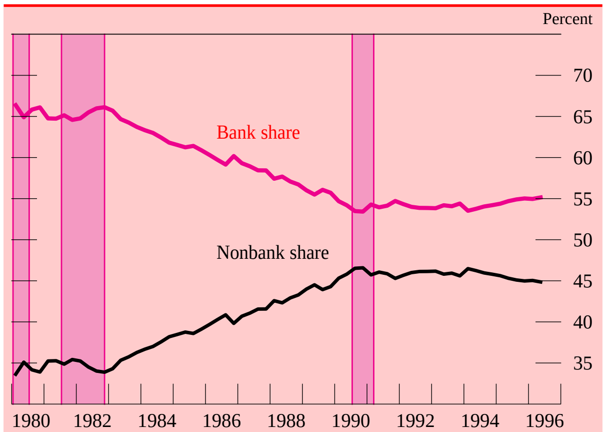
7. See Cole and Wolken, ''Financial Services Used by Small Businesses.''

8. For a description of the changes in state laws, see Dean Amel, ''State Laws Affecting the Geographic Expansion of Commercial Banks,'' Board of Governors of the Federal Reserve System, September 1993; and Donald T. Savage, ''Interstate Banking: A Status Report,'' *Federal Reserve Bulletin*, vol. 79 (December 1993), pp. 1075–89.

9. A number of studies have found that failing banks are much less efficient than other banks. See Allen N. Berger and David B. Humphrey, ''Measurement and Efficiency Issues in Commercial Banking,'' in Z. Griliches, ed., *Output Measurement in the Service Sectors*, National Bureau of Economic Research, Studies in Income and Wealth, vol. 56 (University of Chicago Press, 1992), pp. 221–49; Richard Barr and Thomas Siems, *Predicting Bank Failure Using DEA to Quantify Management Quality*, Federal Reserve Bank of Dallas, Financial Industry Studies Working Paper 1–94, January 1994; Robert DeYoung and Gary Whalen, ''Is a Consolidated Banking Industry a More Efficient Banking Industry?'' Office of the Comptroller of the Currency, *Quarterly Journal*, vol. 13 (September 1994), pp. 11–21; and David C. Wheelock and Paul W. Wilson, ''Explaining Bank Failures: Deposit Insurance, Regulation, and Efficiency,'' *Review of Economics and Statistics*, vol. 77 (November 1995), pp. 689–700.

1. Bank and nonbank shares of total nonfarm nonfinancial business loans, 1980–96:Q2



NOTE. Total nonfarm nonfinancial business loans are calculated as the sum of "bank loans" and "other loans and advances" at nonfarm nonfinancial corporations and nonfarm noncorporate businesses, as defined by the Federal Reserve Board's flow of funds accounts. Data are quarterly. Shaded areas denote periods of business recession as defined by the National Bureau of Economic Research.

has been the subject of much debate and is beyond the scope of this article.[10] However, harsher economic conditions undoubtedly had adverse effects on the use of credit for small businesses, especially the use of mortgage credit. Consequently, any comparisons of credit use in 1987, a year far along into a seven-year expansion, with credit use in 1993, a year early in the current expansion, will undoubtedly be affected by differences in macroeconomic conditions.

The combination of loan losses, the weak economy, and more stringent regulation led many depositories initially to tighten the terms and standards for underwriting commercial loans and strengthen their capital positions. A Board survey of senior loan officers indicated that standards for approving commercial loans tightened, on net, throughout 1990–92 and only began to ease during 1993. And bank Call Report data show that the average leverage capital ratio for the industry rose from 6.2 percent in 1990 to 7.6 percent in 1993.

In this article, market shares rather than aggregate dollar amounts are compared. If all types of lenders and borrowers react to the business cycle in a similar fashion, then these comparisons should be valid. If, however, during a recession, banks reduce lending more than nonbank lenders, some of the observed changes in market shares would be a result of these differing responses. But banks' share declined throughout the 1987–90 period (chart 1) and increased during the latter stages of the 1990–91 recession. Hence, the overall decline in banks' dollar share of small business lending should not be attributed to differing responses to the recession.

Types of Credit Used by Small Businesses

Both of the NSSBFs collected information on six types of credit to small businesses—credit lines used, mortgage loans, equipment loans, motor vehicle loans, capital leases, and "other" loans.[11] Credit lines used represent loans taken down under an agreement by a lender to provide up to a specified amount of credit for part or all of a specified period. Because the borrower has the option of taking down part or all of the credit for part or all of the specified period, credit lines provide the most flexibility in funding. Credit lines are typically used to finance working capital needs and are often collateralized by assets unrelated to the use of the credit line. In contrast, mortgage loans, equipment loans, motor vehicle loans, and capital leases are typically used to finance specific assets and are typically collateralized by the assets being financed. "Other" loans refer to loans not elsewhere classified, primarily unsecured term loans and loans collateralized by assets other than real estate, equipment, and motor vehicles and not taken down under credit lines.[12]

From 1987 to 1993, the distribution of the total dollar value of credit used by small businesses across loan types changed significantly (table 1). In both years, about three-fifths of the aggregate dollar amount of small business credit was in the form of credit lines used and mortgages; but in 1993, the

10. Joe Peek and Eric Rosengren link regulatory enforcement actions and the shrinkage of bank loans to sectors likely to be bank dependent ("Bank Regulation and the Credit Crunch," *Journal of Banking and Finance*, vol. 19, 1995, pp. 679–92), and tie changes in bank capital to changes in deposits ("The Capital Crunch: Neither a Borrower nor a Lender Be," *Journal of Money, Credit, and Banking*, vol. 27, August 1995, pp. 625–38). In contrast, Allen N. Berger and Gregory S. Udell conclude that the quantitative effects of the new capital regulations were not substantial ("Did Risk-Based Capital Allocate Bank Credit and Cause a Credit Crunch in the U.S.?" *Journal of Money, Credit, and Banking*, vol. 26, August 1994, pp. 585–628). However, they do not rule out regulatory pressure as a reason for some of the banking industry's credit reallocation during the early 1990s.

11. Both surveys collected information about trade credit, and the 1993 survey also collected information about credit card debt used for business purposes; these two types of credit are not analyzed in this article.

12. Other loans refer to loans that a survey respondent reported after being queried about any credit lines, mortgages, equipment loans, motor vehicle loans, and capital leases. Some of the loans classified as "other" likely should be in another category, but the surveys did not collect sufficient information to permit accurate reclassifications.

1. Distribution of the dollar amount of small business credit outstanding, by credit type, 1987 and 1993

Percent except as noted

Credit type	1987	1993	Change (percentage points)
Credit lines used[1]	34.0	44.1	10.1*
Mortgage loans[2]	31.2	13.9	–17.3*
Equipment loans	10.5	11.3	.8
Motor vehicle loans	6.1	6.0	–.1
Capital leases	4.0	6.2	2.2*
Other loans[3]	14.3	18.6	4.4*
Total	**100**	**100**	. . .

1. Amounts drawn down under credit lines.
2. Includes both commercial mortgages and residential mortgages if funds were used for business purposes.
3. For definition, see text note 12.
* Statistically significant at the 95 percent confidence level (that is, the probability that any change occurred with the same sign is at least 95 percent). See the appendix for a discussion of some of the statistical techniques used.

2. Comparison of the distributions of the dollar amount of small business credit outstanding at banks and nonbanks, by credit type, 1987 and 1993

Percent except as noted

Credit type	Banks			Nonbanks[1]		
	1987	1993	Change (percentage points)	1987	1993	Change (percentage points)
Credit lines used[2]	41.9	55.2	13.3	20.3	26.4	6.1
Mortgage loans[3]	31.0	14.4	–13.4	31.4	13.2	–18.2
Equipment loans	10.0	11.0	1.0	11.4	11.7	.3
Motor vehicle loans	5.1	4.9	–.2	7.9	7.7	–.2
Capital leases	1.5	2.8	1.3	8.4	11.6	3.2
Other loans[4]	10.6	11.7	1.1	20.6	29.5	8.9
Total	**100**	**100**	. . .	**100**	**100**	. . .

1. Nonbanks consist of thrift institutions (savings and loan associations, savings banks, and credit unions), finance companies, insurance companies, mortgage companies, leasing companies, brokerage firms, other business firms, families and individuals, and government sources of credit.
2. Amounts drawn down under credit lines.
3. Includes both commercial mortgages and residential mortgages if funds were used for business purposes.
4. For definition, see text note 12.

share for mortgages had plummeted from 31.2 percent to only 13.9 percent, while that for credit lines used had risen from 34.0 percent to 44.1 percent. Much of this shift may be attributed to upheavals in the commercial real estate market, in which, as noted previously, property values declined almost one-third during the early 1990s. To the extent that these properties were leveraged, borrowers passed losses on to mortgage lenders, who responded by curtailing new real estate lending. With the exception of motor vehicle loans, other types of credit (equipment loans, capital leases, and other loans) registered small gains in market share from 1987 to 1993 at the expense of mortgages. These results are consistent with the 1996 survey conducted for the *American Banker*, which showed that small businesses have increased their reliance on credit lines and leases at the expense of traditional loans.[13]

The same overall trends in the types of credit used by small businesses are also evident in the shares of different credit types held by banks and nonbanks, in that credit lines used grew in importance while mortgages declined in importance (table 2). However, the proportions of credit types in the portfolios of banks and nonbanks are quite different. In 1993, for example, credit lines used accounted for more than half of all bank credit extended to small businesses but only slightly more than one-fourth of all nonbank credit to small businesses.

Among nonbanks, thrift institutions shifted their portfolio out of mortgages and into each of the five other types of credit, more than doubling their allocation to equipment and motor vehicle loans (table 3). Finance companies reduced their allocation to mortgages only slightly, while shifting portfolio share from equipment, motor vehicle, and other loans into credit lines used. As a result of these changes, in 1993 credit lines used accounted for more than half of all finance company lending to small businesses. Nonbanks other than thrift institutions and finance companies were the only group of lenders whose portfolio share of credit lines used declined from 1987 to 1993. Other nonbanks shifted out of mortgages primarily into other loans.

BANK AND NONBANK SHARES OF SMALL BUSINESS CREDIT

From 1987 to 1993, banks lost to nonbanks 2 percentage points of their share of the small business credit market (table 4). This finding is consistent with the hypothesis that nonbanks are eroding banks' market share of credit to firms that are too small to gain direct access to money and capital markets. The magnitude of the decline is small, however (banks still had three-fifths of the market in 1993) and lacks statistical significance.[14] Moreover, bank lending to businesses has rebounded strongly since 1993. Evidence from bank Call Reports shows that, after declining from $633 billion as of June 1991 to $593 billion as of June 1993, commercial and industrial loans grew to $737 billion as of June 1996. This growth in overall business lending suggests that

13. See "Credit Lines, Leasing in Demand."

14. The estimated 2 percent decline in the bank share is significantly different from zero at the 74 percent level of confidence.

3. Distribution of the dollar amount of small business credit at nonbank sources, by type of credit, 1987 and 1993

Percent except as noted

Credit type	Thrift institution			Finance company			Other nonbank[1]		
	1987	1993	Change (percentage points)	1987	1993	Change (percentage points)	1987	1993	Change (percentage points)
Credit lines used[2]	16.8	22.4	5.6	32.3	51.2	18.9	14.2	8.9	–5.3
Mortgage loans[3]	60.9	39.3	–21.6	7.5	6.3	–1.2	34.4	13.0	–21.4
Equipment loans	1.6	6.1	4.5	22.5	16.7	–5.8	8.5	9.1	.6
Motor vehicle loans	3.1	7.4	4.3	20.0	14.5	–5.5	2.1	2.7	.6
Capital leases	3.8	5.9	2.1	5.4	7.4	2.0	12.1	15.8	3.7
Other loans[4]	13.7	18.8	5.1	12.2	3.9	–8.3	28.7	50.5	21.8
Total	**100**	**100**	**. . .**	**100**	**100**	**. . .**	**100**	**100**	**. . .**

1. Other nonbanks consist of brokerage firms, leasing companies, insurance and mortgage companies, other business firms, government sources, and individuals.
2. Amounts drawn down under credit lines.
3. Includes both commercial mortgages and residential mortgages if funds were used for business purposes.
4. For definition, see text note 12.

banks may have regained market share in the small business credit market since the 1993 NSSBF.

Changes in bank and nonbank shares of the total dollar amount of small business credit from 1987 to 1993 varied by type of credit (table 4). Mortgage loans' share of small business credit declined more than half at both banks and nonbanks, with bank mortgages falling from 19.7 percent to 8.8 percent of the small business credit market and nonbank mortgages falling from 11.5 percent to 5.1 percent. The changes for credit lines, however, were quite different at banks and nonbanks. Bank credit lines grew by just more than one-fourth to 33.8 percent, while nonbank credit lines grew by more than one-third to 10.2 percent. These figures suggest that nonbanks increased their share of the market for small business credit lines used over the same period that credit lines were growing in importance to small businesses. In another development, capital leases grew in importance for both banks and nonbanks. Bank capital leases almost doubled from 0.9 percent to 1.7 percent of all small business credit, while nonbank capital leases grew from 3.1 percent to 4.5 percent.

To see how these changes in market shares affected specific types of nonbanks, credit shares of each type of nonbank are shown in table 5. As the thrift industry declined over 1987–93, thrift institutions' share of small business credit fell from 7.4 percent to 4.0 percent. When combined with commercial banks' decline of 2.0 percentage points, depository institutions (commercial banks and thrift institutions) lost 5.4 percentage points of market share to nondepository nonbanks. Finance companies reaped the greatest gain in market share, with an increase from 11.4 percent to 14.7 percent. Leasing companies more than doubled their market share from 1.5 percent to 3.5 percent, while brokerage companies increased their share from an almost nonexistent 0.1 percent to 1.4 percent.[15] Insurance and mortgage

15. Brokerage company credit consists primarily of lines of credit used.

4. Distribution of the dollar amount of all small business credit outstanding, by type of credit at banks and nonbanks, 1987 and 1993

Percent except as noted

Credit type	Bank			Nonbank			Total	
	1987	1993	Change (percentage points)	1987	1993	Change (percentage points)	1987	1993
Credit lines used[1]	26.5	33.8	7.3*	7.5	10.2	2.7	34.0	44.1
Mortgage loans[2]	19.7	8.8	–10.8*	11.5	5.1	–6.4*	31.2	13.9
Equipment loans	6.3	6.8	.5	4.2	4.5	.3	10.5	11.3
Motor vehicle loans	3.2	3.0	–.2	2.9	3.0	.1	6.1	6.0
Capital leases	.9	1.7	.8*	3.1	4.5	1.4*	4.0	6.2
Other loans[3]	6.7	7.2	.5	7.6	11.4	3.8*	14.3	18.6
All	**63.3**	**61.3**	**–2.0**	**36.7**	**38.7**	**+2.0**	**100**	**100**

1. Amounts drawn down under credit lines.
2. Includes both commercial mortgages and residential mortgages if funds were used for business purposes.
3. For definition, see text note 12.

* Statistically significant at the 95 percent confidence level.

** Statistically significant at the 90 percent confidence level. See the appendix.

5. Distribution of the dollar amount of all small business credit outstanding, by type of credit and type of nonbank, 1987 and 1993

Percent

Credit type	Thrift institution		Finance company		Brokerage company		Leasing company		Insurance and mortgage companies		Business and government		Individuals		Total	
	1987	1993	1987	1993	1987	1993	1987	1993	1987	1993	1987	1993	1987	1993	1987	1993
Credit lines used[1]	1.2	.9	3.7	7.5	.1	.7	.0	.0	.0	.1	2.4	.4	.0	.6	7.5	10.2
Mortgage loans[2]	4.5	1.6	.9	.9	.0	.3	.0	.0	.9	.9	1.5	.5	3.7	.9	11.5	5.1
Equipment loans	.1	.2	2.6	2.5	.0	.0	.1	.6	.1	.1	1.0	.9	.4	.2	4.2	4.5
Motor vehicle loans	.2	.3	2.3	2.1	.0	.0	.1	.3	.0	.0	.3	.1	.0	.1	2.9	3.0
Capital leases	.3	.2	.6	1.1	.0	.0	1.2	2.5	.0	.0	.8	.3	.2	.4	3.1	4.5
Other loans[3]	1.0	.8	1.4	.6	.0	.4	.0	.0	.4	.8	1.7	4.1	3.0	4.7	7.6	11.4
Total	**7.4**	**4.0**	**11.4**	**14.7**	**.1**	**1.4**	**1.5**	**3.5**	**1.4**	**1.9**	**7.6**	**6.3**	**7.3**	**6.8**	**36.7**	**38.7**

NOTE. Components may not sum to totals because of rounding.
1. Amounts drawn down under lines of credit.
2. Includes both commercial mortgages and residential mortgages if funds were used for business purposes.
3. For definition, see text note 12.

companies saw a modest gain, whereas the shares of credit extended by other business firms and government and by individuals dropped.

A slightly different perspective on the relative importance of bank and nonbank lending is gained by looking at changes in their shares of the total outstanding dollar amount of each credit type (table 6).[16] Banks suffered losses in the market shares of credit lines used, motor vehicle loans, and other loans, while gaining share in the markets for capital leases and, to a lesser extent, for mortgages.

Changes in market shares of the total dollar amount of each credit type also were evident among different types of nonbanks (table 7). Thrift institutions lost almost half of their shares of credit lines used, capital leases, and other loans, but doubled their share of equipment loans and made sizable gains in their share of motor vehicle loans. Finance companies made strong gains in the market for credit lines, increasing their share 6.3 percentage points from 10.8 percent to 17.1 percent. Finance companies also more than doubled their presence in the small business market for mortgage credit. This increase should be kept in perspective, however, as the mortgage share of all small business credit declined more than half over this period (table 1). Other nonbanks registered large gains in the market for other loans, with individuals and other businesses and government being the primary sources for these loans.

A comparison of the bank and nonbank shares of the aggregate amount of credit used by small businesses as categorized by various characteristics of the firms and their primary owners also shows changes from 1987 to 1993 (table 8). Banks lost market share

16. The data in tables 4 and 5 are used to calculate bank and nonbank market shares of the total outstanding dollar amount of each credit type. Each credit type's bank and nonbank share of total credit is divided by the sum of bank and nonbank shares. For example, in 1987 bank credit lines accounted for 26.5 percent of all small business credit, and nonbank credit lines accounted for an additional 7.5 percent, for a total of 34.0 percent. Banks' share of the market for small business credit lines is then calculated as 26.5 percent divided by 34.0 percent, which yields 77.9 percent as the bank share of the small business market for credit lines. Repeating these calculations for each loan type produces the figures in tables 6 and 7. (Figures in the tables may be slightly different because of rounding.)

6. Distribution of the dollar amount of each type of small business credit outstanding at banks and nonbanks, 1987 and 1993

Percent except as noted

Credit type	Banks			Nonbanks			Total	
	1987	1993	Change (percentage points)	1987	1993	Change (percentage points)	1987	1993
Credit lines used[1]	78.0	76.8	−1.2	22.0	23.2	1.2	100	100
Mortgage loans[2]	63.1	63.4	.3	36.9	36.6	−.3	100	100
Equipment loans	60.0	60.0	.0	40.0	40.0	.0	100	100
Motor vehicle loans	52.5	50.0	−2.5	47.5	50.0	2.5	100	100
Capital leases	23.0	28.0	5.0	77.0	72.0	−5.0	100	100
Other loans[3]	46.9	38.6	−8.3	53.1	61.4	8.3	100	100
All	**63.3**	**61.3**	**−2.0**	**36.7**	**38.7**	**2.0**	**100**	**100**

1. Amounts drawn down under credit lines.
2. Includes both commercial mortgages and residential mortgages if funds were used for business purposes.
3. For definition, see text note 12.

primarily at medium-sized small businesses (firms with 5–19 employees or between $100,000 and $1 million in annual sales), which account for approximately one-fourth of all small business credit (memo columns). Although banks' market share of credit used by women-owned firms increased from 50.1 to 54.5 percent, their market share of credit used by minority-owned firms fell 13.2 percentage points, from 66.4 to 53.2 percent.

Banks gained market share in markets where competition among banks (as measured by the Herfindahl concentration index) was low or high, but lost share where competition among banks was classified as moderate (table 8).[17] In high-concentration markets, primarily small rural areas, local banks face little competition from other banks or from nonbanks and, therefore, would be expected to maintain their share. In fact, banks gained market share in rural markets while losing share in urban markets. In medium-concentration markets, which tend to be smaller urban and larger rural areas, banks faced limited competition from other banks and from nonbanks, but nonetheless clearly lost market share to nonbanks. In low-concentration markets, primarily large urban areas, banks compete vigorously both with other banks and with nonbanks and have gained market share. This suggests that nonbanks are more effective when competing with banks that are somewhat, but not completely, sheltered from competition. However, there are many different but interrelated factors at work here, so that any definitive conclusions require a more rigorous analysis that accounts for these relationships.

17. The Herfindahl index is a measure of market concentration calculated as the sum of the squares of each bank's market share, which is defined in terms of total bank deposits. The index ranges from zero (perfect competition) to one (perfect monopoly). In this article, markets with indexes of less than 0.10 are considered competitive; those with indexes of 0.10 to 0.18, moderately concentrated; and those with indexes of more than 0.18, highly concentrated. These categories correspond to those defined in the ''Horizontal Merger Guidelines,'' issued by the U.S. Department of Justice and the Federal Trade Commission, April 2, 1992.

INCIDENCE OF SMALL BUSINESS CREDIT

This section analyzes the ''incidence'' of small business credit, which is defined as the percentage of firms using credit of a certain type or from a particular source. In contrast to the analysis of credit shares in the previous section, the analysis of incidence is not dependent on the size of the credit and therefore gives a clearer picture of what sources and types of credit were used by the ''typical'' small business.[18]

In 1993, 54.1 percent of small businesses used some form of credit, down from 60.1 percent in 1987 (table 9). This finding most likely reflects the different macroeconomic conditions of the two periods but may also reflect other factors, such as the effects of FIRREA, FDICIA, and the growing use of credit card debt to finance small businesses.[19] As with the

18. Direct comparisons of the number of firms using credit services in 1987 and 1993 should not be made because of differences in the coverage of the two surveys. Both surveys obtained lists of businesses from Dun and Bradstreet, Inc., which expanded its coverage of small, retail, and business service firms in the years between the two surveys. Therefore, the 1993 survey is more broadly representative of such firms, and valid comparisons between the 1987 and 1993 surveys can be made only after accounting for these differences in coverage (see the appendix).

19. Because only the 1993 NSSBF collected data on the use of personal and business credit card debt for business purposes, changes in the use of such debt cannot be analyzed. Nevertheless, use of credit card debt for business was widespread in 1993, with 39.2 percent of firms reporting business use of personal credit card debt and 27.6 percent of firms reporting use of business credit card debt. (See Cole and Wolken, ''Financial Services Used by Small Businesses.'')

7. Distribution of the dollar amount of each type of small business credit outstanding, by type of nonbank, 1987 and 1993

Percent except as noted

Credit type	Thrift institutions			Finance companies			Other nonbanks[1]			MEMO: Nonbank total	
	1987	1993	Change (percentage points)	1987	1993	Change (percentage points)	1987	1993	Change (percentage points)	1987	1993
Credit lines used[2]	3.7	2.1	–1.6	10.8	17.1	6.3**	7.5	4.0	–3.5	22.0	23.2
Mortgage loans[3]	14.4	11.4	–3.0	2.8	6.6	3.8	19.8	18.6	–1.2	36.9	36.6
Equipment loans	1.1	2.2	1.1	24.4	21.8	–2.7	14.5	16.1	1.6	40.0	40.0
Motor vehicle loans	3.8	5.0	1.3	37.4	35.9	–1.5	6.3	9.1	2.8	47.5	50.0
Capital leases	7.1	3.8	–3.2	15.6	17.4	1.8	54.3	50.7	–3.6	77.0	72.0
Other loans[4]	7.1	4.1	–3.0	9.8	3.1	–6.7**	36.2	54.2	18.0*	53.1	61.4
All	**7.4**	**4.0**	**–3.4***	**11.4**	**14.7**	**3.3**	**17.9**	**19.9**	**2.0**	**36.7**	**38.7**

1. Other nonbanks consist of leasing companies, brokerage firms, mortgage and insurance companies, other business firms, government sources, and individuals.
2. Amounts drawn down under credit lines.
3. Includes both commercial mortgages and residential mortgages if funds were used for business purposes.
4. See text note 12.
* Statistically significant at the 95 percent confidence level.
** Statistically significant at the 90 percent confidence level. See the appendix.

8. Total dollar amount of small business credit outstanding, grouped by selected characteristics and distributed by type of issuer, 1987 and 1993

Percent except as noted

Characteristics of firm, owner, and market	Banks			Nonbanks			MEMO: Credit for firm category as a percentage of all small business credit		
	1987	1993	Change (percentage points)	1987	1993	Change (percentage points)	1987	1993	Change (percentage points)
CHARACTERISTIC OF FIRM									
Number of employees									
Fewer than 5	56.4	56.9	.5	43.6	43.1	–.5	18.6	17.8	–.8
5–9	54.7	50.9	–3.8	45.3	49.1	3.8	12.1	12.2	.1
10–19	67.8	54.7	–13.1	32.2	45.3	13.1	10.3	12.4	2.1
20–499	66.5	66.3	–.2	33.5	33.7	.2	59.0	57.6	–3.4
Annual sales (in thousands of 1993 dollars)									
100 or less	50.2	49.5	–.7	49.8	50.5	.7	3.4	5.2	1.8
101–1,000	56.0	52.8	–3.2	44.0	47.2	3.2	28.4	26.0	–2.4
More than 1,000	67.0	65.4	–1.6	33.0	34.6	1.6	68.2	68.8	.6
Age (years)									
5 or less	59.5	58.7	–.8	40.5	41.3	.8	12.8	21.7	8.9
More than 5	63.8	62.1	–1.7	36.2	37.9	1.7	87.2	78.3	–8.9
RACE, ETHNICITY, AND SEX OF MAJORITY OWNER									
Nonwhite or Hispanic	66.4	53.2	–13.2	33.6	46.8	13.2	5.3	7.8	2.5
White Non-Hispanic	63.1	62.0	–1.1	36.9	38.0	1.1	94.7	92.2	–2.5
Female	50.1	54.5	4.4	49.9	45.5	–4.4	7.5	11.7	4.2
Male	64.4	62.2	–2.2	35.6	37.8	2.2	92.5	88.3	–4.2
MARKET CHARACTERISTIC									
Urbanization									
Urban	63.3	60.3	–3.0	36.7	39.7	3.0	79.0	82.4	3.4
Rural	63.3	66.2	2.9	36.7	33.8	–2.9	21.0	17.6	–3.4
Banking market concentration[1]									
Low	67.6	70.1	2.5	32.4	29.9	–2.5	12.5	10.0	–2.5
Moderate	64.2	57.4	–6.8	35.8	42.6	6.8	38.7	42.9	4.2
High	61.4	63.1	1.6	38.6	36.9	–1.6	48.8	47.1	–1.7
All firms	**63.3**	**61.3**	**–2.0**	**36.7**	**38.7**	**2.0**	**100**	**100**	**. . .**

1. As measured by the Herfindahl index. Low = less than 0.10, moderate = 0.10–0.18, and high = more than 0.18.

decline in the *dollar share* of small business borrowing, the type of credit whose *usage* (incidence) declined the most is mortgage loans. In both years, the most widely used types of credit were credit lines and motor vehicle loans.

As they did in the case of market share, banks also lost ground to nonbanks in overall credit incidence. From 1987 to 1993, the percentage of small businesses using bank credit services declined from 44.0 percent to 36.8 percent, while the percentage of firms using nonbank credit services was flat at 32.2 percent (table 9). The percentage of small businesses using bank credit services declined for each type of credit except credit lines and capital leases. Banks were the most important supplier of credit lines in both 1987 and 1993 and were used by one out of five small businesses to obtain credit lines—more than four times the incidence for nonbanks. The percentage of small businesses using nonbank credit declined for mortgages and other loans but rose for credit lines, equipment loans, motor vehicle loans, and capital leases. In 1993, nonbanks equaled or exceeded banks in the percentage of small businesses to which they provided capital leases and other loans and trailed only slightly in equipment and motor vehicle loans.

To assess the relative importance of thrift institutions and finance companies among nonbanks, their results are tabulated against those of all other nonbank sources (table 10). The percentage of small businesses using thrift institutions for credit services remained constant from 1987 to 1993, even though thrift institutions lost more than half their share of the dollar value of small business credit over the period. This finding is consistent, however, with the shift by thrift institutions from providing mortgages (–1.2 percentage points), which typically are large in amount, to credit lines (+0.5 percentage points) and

9. Percentage of small businesses using selected credit services from all sources and from banks and nonbanks, 1987 and 1993

Credit type	All sources 1987	All sources 1993	All sources Change (percentage points)	Bank 1987	Bank 1993	Bank Change (percentage points)	Nonbank 1987	Nonbank 1993	Nonbank Change (percentage points)
Any credit	60.1	54.1	−6.1*	44.0	36.8	−7.2*	32.2	32.2	.0
Credit lines	21.4	24.0	2.6*	19.5	20.6	1.1	2.7	4.7	2.0*
Mortgage loans[1]	15.5	5.8	−9.7*	9.9	3.9	−6.0*	6.2	2.2	−4.0*
Equipment loans	12.8	13.9	1.1	7.9	7.5	−.4	5.7	7.4	1.7*
Motor vehicle loans	24.4	24.1	−.3	14.0	13.1	−.9	11.9	12.7	.8
Capital leases	7.2	9.1	1.9*	1.7	1.7	.0	5.8	7.9	2.1*
Other loans[2]	14.1	11.0	−3.1*	6.7	4.2	−2.4*	8.0	7.4	−.6

NOTE. Firms may have multiple credit accounts at multiple sources.

1. Includes both commercial mortgages and residential mortgages if funds were used for business purposes.

2. For definition, see text note 12.

* Statistically significant at the 95 percent confidence level.

motor vehicle loans (+0.6 percentage points), which are smaller. In fact, small businesses were more likely to use thrift institutions in 1993 for credit lines and motor vehicle loans than for mortgages.

The percentage of small businesses using finance companies for credit services declined slightly, from 12.0 percent to 11.6 percent. Smaller proportions of firms used finance companies for mortgages, motor vehicle loans, and other loans, while larger proportions used them for credit lines, equipment loans, and capital leases.

In 1993, 19.6 percent of small businesses used other nonbanks (nonbanks other than thrift institutions and finance companies) for credit services, a level 1.2 percentage points higher than in 1987; other nonbanks lost ground only in mortgage loans. Among other nonbanks, leasing companies (not shown in table 10) made the most headway in serving small businesses. The percentage of small businesses borrowing from other nonbanks increased from 4.3 percent in 1987 to 7.6 percent in 1993—a gain accounted for almost entirely by capital leases and motor vehicle loans.

SUMMARY

This article analyzes data from the National Survey of Small Business Finances for 1987 and for 1993 regarding bank and nonbank competition in the market for small business credit. The results indicate that banks have lost market share but only slightly—about 2 percentage points. Moreover, bank lending has strongly rebounded since 1993, suggesting that this loss may have been reversed subsequent to the period covered by the surveys.

According to the survey results, banks provided more than 60 percent of the dollar volume of credit in both survey years, excluding trade credit and credit card debt, and dominated in the provision of credit lines. However, the percentage of firms obtaining credit from banks dropped significantly, from 44.0 percent in 1987 to only 36.8 percent in 1993, while the percentage of firms obtaining credit from nonbanks was stable at about 32 percent. Nonbanks made significant gains in the percentage of small businesses that used them to obtain credit lines, equipment loans, and capital leases; however, banks

10. Percentage of small businesses using selected credit services at selected types of nonbanks, 1987 and 1993

Credit type	Thrift institution 1987	Thrift institution 1993	Thrift institution Change (percentage points)	Finance company 1987	Finance company 1993	Finance company Change (percentage points)	Other nonbank[1] 1987	Other nonbank[1] 1993	Other nonbank[1] Change (percentage points)
Any credit	6.1	6.1	.0	12.0	11.6	−.4	18.4	19.6	1.2
Credit lines	1.6	2.1	.5	.7	1.1	.4	.5	1.6	1.1
Mortgage loans[2]	2.2	1.0	−1.2	.5	.2	−.3	3.7	1.0	−2.7
Equipment loans	.5	.6	.1	1.6	2.0	.4	3.6	5.0	1.4
Motor vehicle loans	1.8	2.4	.6	8.6	7.8	−.8	1.7	2.8	1.1
Capital leases	.1	.2	.1	1.2	1.9	.7	4.8	6.3	1.5
Other loans[3]	1.1	.5	−.6	.4	.2	−.2	6.6	6.7	.1

NOTE. Firms may have multiple credit accounts at multiple sources.

1. Other nonbanks consist of leasing companies, brokerage firms, mortgage and insurance companies, other business firms, government sources, and individuals.

2. Includes both commercial mortgages and residential mortgages if funds were used for business purposes.

3. For definition, see text note 12.

made significant gains in the percentage of firms using them to obtain mortgages.

Among nonbanks, the data indicate that thrift institutions lost almost half their share of the small business credit market over the 1987–93 period, falling from 7.4 percent to 4.0 percent of the dollar amount of credit. The losses of market share by banks and thrift institutions primarily accrued to finance companies, leasing companies, and brokerage firms.

The results presented here must be viewed with caution. Many of the factors we analyze are interrelated, and definitive conclusions cannot be drawn until more powerful statistical methods can be brought to bear upon this issue. Moreover, we do not examine bank and nonbank competition in the provision of transaction account and financial management services—markets traditionally dominated by banks. These are important and promising areas for future research.

APPENDIX: BACKGROUND, WEIGHTING ADJUSTMENTS, AND VARIANCE ESTIMATES

The 1987 and 1993 NSSBFs were conducted for different purposes. The 1993 survey focused on the availability of credit to small and minority-owned businesses, whereas the 1987 survey focused on the definition of banking markets. Consequently, respondents to each survey answered a different set of questions, but all respondents provided a complete roster of their firms' finances, including information about the firms' credit lines, loans, and leases.[20] Interviewers conducted each survey using a system known as computer-assisted telephone interviewing to enter the responses directly into a computerized survey database. Research Triangle Institute conducted the 1987 survey, with the interviews from September 1988 through September 1989. Price Waterhouse conducted the 1993 survey, with interviews from March 1994 through February 1995. The list from which the sample was drawn (the sampling frame) for both surveys was the current (December 1987 and November 1993) Dun and Bradstreet Market Identifier (DMI) file. This continually updated file combines records derived from the traditional Dun and Bradstreet credit-rating program with records derived from business telephone listings. Because the DMI frame includes firms that are outside the scope of the surveys, interviewers first screened firms for eligibility, then in the full or "primary" interview surveyed eligible firms as well as the firms for which eligibility could not be determined.

The sample selection for both surveys incorporated stratified random sampling with stratification by urbanization of location (that is, urban or rural), number of employees, and census region. Large firms were oversampled in both surveys. However, the two sample designs differed from each other in significant ways.[21]

The 1987 NSSBF used twenty-four strata constructed as follows: two urbanization categories (urban or rural location), three size categories of firms according to the number of employees (1–49, 50–99, and 100 or more), and four Census regions. In 1987 the screening interview yielded an eligibility rate of 66 percent, and the primary interview yielded a 65.5 percent response rate. A set of analysis weights enabled researchers to account for sample design, eligibility, and differential response.

The 1993 NSSBF sample design employed ninety-seven strata constructed from four partitions of the sample frame—one main partition and three minority partitions of likely Asian-, Black-, and Hispanic-owned firms respectively. The main partition was divided into ninety sampling strata defined by the two urbanization categories, five size categories of firms according to the number of employees (1–19, 20–49, 50–99, 100–499, and unknown), and nine Census regions. Each of the three minority partitions was divided by urbanization for a total of six minority strata. A ninety-seventh stratum was defined to account for firms that were listed on the DMI file with more than 500 employees and that had fewer than 500 when surveyed. The best estimate of the eligibility rate is 68.2 percent, and the overall response rate was 59.5 percent.[22] The computation of the analysis weights for the 1993 survey is more complicated than that for the 1987 survey. For 1993, DMI data were used to compute an adjustment for eligibility and nonresponse.

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20. The analysis excluded firms classified as real estate operators, lessors, subdividers, and developers, resulting in the exclusion of 66 firms from the 1987 survey and 101 firms from the 1993 survey. These firms were identified by their respective four-digit Standard Industrial Classifications, 6512 (Real Estate Operators and Lessors) and 6552 (Real Estate Subdividers and Developers).

21. For a detailed description of the 1987 survey, see Brenda G. Cox, Gregory E. Elliehausen, and John D. Wolken, *The National Survey of Small Business Finances: Final Methodology Report, RTI Report RTI/4131-00F* (Research Triangle Park, N.C.: Research Triangle Institute, 1989); and for the 1993 survey description, see Price Waterhouse, "The National Survey of Small Business Finances Methodology Report," July 1996.

22. For the 1993 survey, eligibility for a large proportion of the sample could not be determined. Thus, the eligibility rate was estimated assuming different scenarios for the nonrespondents. The best estimate proportionately assigned ineligibility status to the nonrespondents.

Besides ''unit nonresponse''—eligible firms that do not provide interviews—analysts must also account for ''item nonresponse'' that results when a respondent fails to provide answers to particular questions. Both unit and item nonresponse are important sources of uncertainty. To provide users of the NSSBF data with a complete working dataset, various models were used to impute the missing values from the available data.[23]

Weighting Adjustments

Analysis weights were adjusted to facilitate proper comparisons of 1987 and 1993 data. Although both surveys used the DMI file as a sampling frame, the types of businesses represented in the file changed significantly between surveys. These changes increased the DMI files' coverage of the smallest firms by adding records for firms identified from third-party lists, such as telephone directories. To adjust for the superior coverage of the 1993 DMI file, the 1987 analysis weights were recalculated so that the distribution of firms by employment size in the 1987 data is the same as that in the 1993 data.[24]

The analysis in this article excluded a small number of firms from each survey because of reporting errors. Each firm with a credit line used, loan, or capital lease accounting for more than 1 percent of the aggregate dollar amount of any credit category was identified. Credit amounts for these firms were then inspected for potential reporting errors that would account for any discrepancies. This inspection identified thirteen firms from the 1987 survey and eighteen firms from the 1993 survey whose data were in error. These firms' records were dropped from the database, and the weights of the remaining firms were recalculated so that the original frequency distribution in each sampling strata was preserved. After these adjustments, the 1987 sample consisted of 3,145 respondents representing 3.2 million firms, and the 1993 sample consisted of 5,237 respondents, representing 4.9 million firms.

Variance Estimates

To obtain estimates of the change in bank shares and incidence shown in tables 1, 4, 6, 7, 8, 9, and 10, estimates of the sampling variance were calculated for use in tests of statistical significance. Although the sampling variance accounts for the major source of error in a survey, other errors may arise at any stage: for example, a respondent may misinterpret a question; an interviewer may miscode a response; an editor may misinterpret a response. Also, the imputation process itself may be a source of error because of the uncertainty associated with any estimation process. However, the dominant source of error, and the easiest to quantify, is the sampling error.[25] For the analysis reported here, sampling variances were computed with the replicate method of bootstrap sampling.[26]

Sampling variance can be estimated using ''replication methods'' that sample from the actual respondents in a way that includes the important dimensions of the original sample design.[27] The bootstrap method is one such technique that is feasible with the NSSBF. Using the bootstrap method involves sampling with replacement—that is, after each selection, cases are replaced in the sampling pool so that they may be selected in a subsequent draw. This operation was performed 400 times, and a set of analysis weights was computed for each of these 400 replicates. In this model, the sampling error of an estimate computed from the full sample (for example, the proportion of firms using credit) is estimated as the standard deviation computed using the 400 bootstrap estimates.

For the 1987 survey, the replicates were selected to preserve the original sampling strata. The analysis weights for the replicates were computed by adjusting the original analysis weights so that the frequencies estimated within sampling strata remained constant. For the 1993 survey, some of the sampling strata had too few respondents and thus were collapsed within employee size classes into ''bootstrap

23. The imputation was similar to that used for the Board's Survey of Consumer Finances. For details, see Arthur B. Kennickell, ''Imputation of the 1989 Survey of Consumer Finances: Stochastic Relaxation and Multiple Imputation,'' *Proceedings of the Section on Survey Research Methods* (American Statistical Association, 1991).

24. Ideally, the weights should be adjusted using the precise difference in the coverage of the 1987 and 1993 DMI frames. This information was not available, however, so the 1993 sample estimate was used as a proxy.

25. For instance, researchers have shown that sampling error is large relative to imputation error in the 1992 Survey of Consumer Finances. (See Arthur B. Kennickell, Douglas A. McManus, and R. Louise Woodburn, ''Weighting Design for the 1992 Survey of Consumer Finances,'' Board of Governors of the Federal Reserve System, Division of Research and Statistics, 1996.)

26. When sampling designs and desired estimators are complex, replicative variance estimators such as the jackknife and the bootstrap are most appropriate. (See R.R. Sitter, ''A Resampling Procedure for Complex Survey Data,'' *Journal of the American Statistical Association*, vol. 87 (September 1992), pp. 755–65.)

27. See Jun Shao and Dongsheng Tu, *The Jackknife and Bootstrap* (Springer-Verlag, 1995).

A.1. Distribution of the dollar amount of small business credit outstanding, by credit type, 1987 and 1993

Percent except as noted

Credit type	1987	1993	Change (percentage points)
Credit lines used[1]	34.0 (2.97)	44.1 (1.40)	10.1 * (3.28)
Mortgage loans[2]	31.2 (2.27)	13.9 (.77)	−17.3 * (2.40)
Equipment loans	10.5 (1.28)	11.3 (.54)	.8 (1.39)
Motor vehicle loans	6.1 (2.13)	6.0 (.32)	−.1 (2.15)
Capital leases	4.0 (.52)	6.2 (.34)	2.2 * (.63)
Other loans[3]	14.3 (1.68)	18.6 (1.02)	4.4 * (1.96)
Total	**100**	**100**	. . .

NOTE. Standard deviations shown in parentheses.

1. Amounts drawn down under credit lines.
2. Includes both commercial mortgages and residential mortgages if funds were used for business purposes.
3. For definition, see text note 12.

* Statistically significant at the 95 percent confidence level.

sampling strata.'' Analysis weights were then computed so that frequencies within the bootstrap sampling strata remained constant.

With the bootstrap replicates and the associated analysis weights developed, the computation of sampling variance is straightforward albeit intensive. Four hundred bootstrap estimates (one from each bootstrap replicate) were computed. Because the bootstrap estimates represent the sampling distribution of the full-sample estimate, the variance of the bootstrap estimates is the estimate of the sampling variance of the full-sample estimate. For example, the incidence of the use of banks for any credit in 1993 is 36.8 percent (table 9, first line). The bootstrap replicate estimates ranged from 34.9 percent to 38.4 percent, with a median of 36.8 percent and a variance of 0.39. The same process was repeated for all share and incidence estimates for 1987 and for 1993.

To test the significance of the changes between 1987 and 1993, a z statistic was computed as follows. The full-sample estimate for 1987 was subtracted from that for 1993 to estimate the difference of the share or incidence measure. The standard deviation of this difference is the square root of the sum of the bootstrap variances of the 1987 and 1993 components. The z statistic is then computed as the estimated difference divided by its standard deviation. The z statistics have an approximate standard normal distribution, so that significance levels indicating whether these estimates are significantly different from zero are easily computed.[28] Table A.1 shows the standard deviations of the data reported in table 1. □

28. For an explanation of tests of significance with normal data, see H. Blalock, Jr., *Social Statistics* (McGraw-Hill, 1972), pp. 93–105.

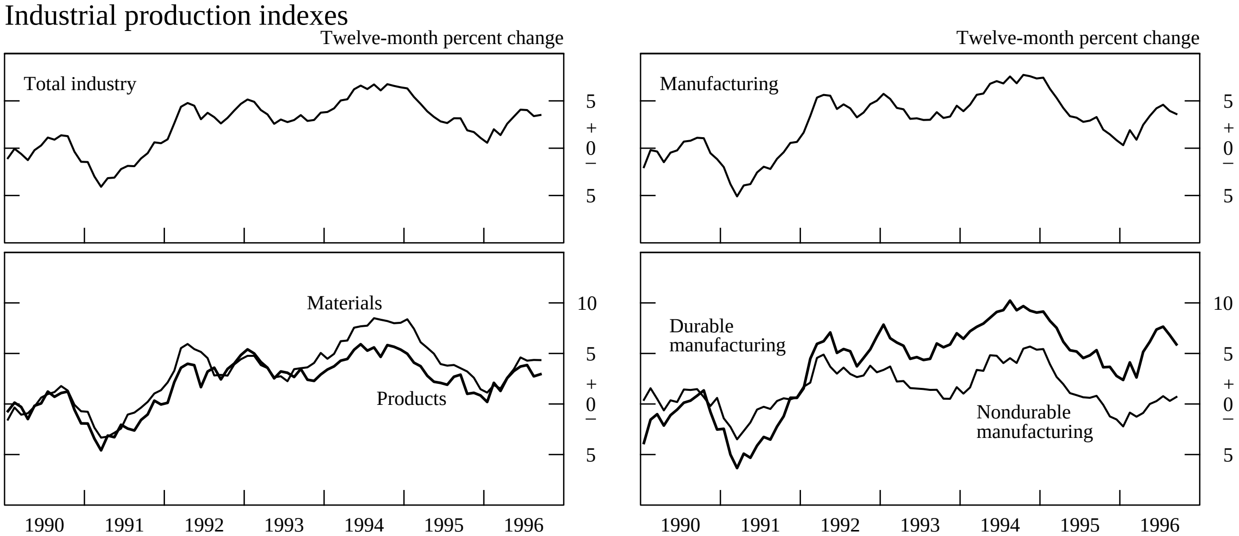
Industrial Production and Capacity Utilization for September 1996

Released for publication October 17

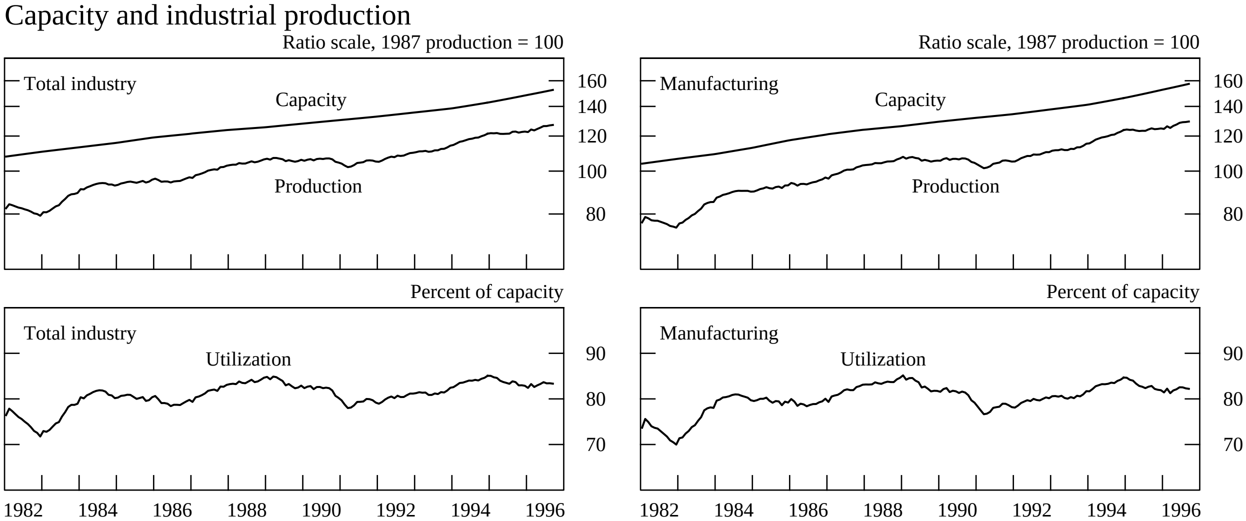
Industrial production increased 0.2 percent in September after a gain of 0.4 percent in August; the August rate is slightly smaller than previously reported. Manufacturing output also increased 0.2 percent in September. The production of motor vehicles and parts, however, fell back about 2 percent for the second straight month. Mining output slipped 0.2 percent, while output at utilities rose 0.4 percent.

At 127.1 percent of its 1987 average, total industrial production in September was 3.5 percent higher than it was in September 1995. Utilization of industrial capacity edged down 0.1 percentage point, to 83.3 percent. Meanwhile, on a quarterly average basis, growth in industrial production slowed from an annual rate of 6.7 percent in the second quarter to 4.4 percent in the third quarter, with the slowdown evident in most major market groups except nondurable consumer goods and durable goods materials.

Industrial production indexes



Capacity and industrial production



All series are seasonally adjusted. Latest series, September. Capacity is an index of potential industrial production.

Industrial production and capacity utilization, September 1996

Category	Industrial production, index, 1987 = 100								
	1996				Percentage change				
					1996[1]				Sept. 1995 to Sept. 1996
	June[r]	July[r]	Aug.[r]	Sept.[p]	June[r]	July[r]	Aug.[r]	Sept.[p]	
Total	**126.4**	**126.4**	**126.8**	**127.1**	**.8**	**.0**	**.4**	**.2**	**3.5**
Previous estimate	126.2	126.3	126.9	. . .	.6	.1	.5	. . .	. . .
Major market groups									
Products, total[2]	122.3	122.6	122.4	122.9	.8	.2	–.1	.4	2.9
Consumer goods	116.8	117.4	116.6	116.6	.4	.5	–.7	.1	.5
Business equipment	168.6	170.1	170.8	172.1	1.6	.9	.4	.8	8.8
Construction supplies	113.9	112.5	113.2	113.5	2.6	–1.3	.7	.2	4.6
Materials	132.6	132.3	133.7	133.7	.8	–.3	1.1	.0	4.3
Major industry groups									
Manufacturing	128.5	129.0	129.1	129.4	.9	.3	.1	.2	3.6
Durable	141.1	141.5	142.2	142.4	1.5	.3	.5	.1	5.9
Nondurable	114.6	115.1	114.6	115.1	.2	.4	–.4	.5	.7
Mining	102.8	101.4	103.8	103.6	2.3	–1.3	2.4	–.2	3.6
Utilities	126.6	123.1	125.2	125.7	–1.4	–2.7	1.7	.4	2.5

Category	Capacity utilization, percent								Memo Capacity, percentage change, Sept. 1995 to Sept. 1996
	Average, 1967–95	Low, 1982	High, 1988–89	1995	1996				
				Sept.	June[r]	July[r]	Aug.[r]	Sept.[p]	
Total	**82.1**	**71.8**	**84.9**	**83.7**	**83.7**	**83.4**	**83.4**	**83.3**	**3.9**
Previous estimate	. . .	. . .	. . .	. . .	83.5	83.3	83.5	. . .	. . .
Manufacturing	81.4	70.0	85.2	82.8	82.6	82.5	82.3	82.2	4.4
Advanced processing	80.7	71.4	83.5	81.1	80.8	80.8	80.7	80.5	5.2
Primary processing	82.6	66.8	89.0	86.9	86.8	86.6	86.3	86.2	2.5
Mining	87.4	80.6	86.5	89.3	91.9	90.7	92.9	92.7	–.1
Utilities	86.9	76.2	92.6	90.7	92.6	90.0	91.4	91.6	1.4

NOTE. Data seasonally adjusted or calculated from seasonally adjusted monthly data.
1. Change from preceding month.
2. Contains components in addition to those shown.
r Revised.
p Preliminary.

When analyzed by market group, the data show that the overall output of consumer goods was little changed in September, as substantial declines in the production of automotive products and other consumer durables were offset by advances in the production of nondurable consumer goods. Motor vehicle assemblies fell 0.5 million units (annual rate) from their August level. The output of other durable consumer goods declined noticeably for the third consecutive month, putting it more than 4 percent below its June level and more than 1 percent below its year-ago level; the weakness in September was concentrated in household furniture, refrigerators, and miscellaneous durable goods. In contrast to the lowered output of consumer durables in September, the production of consumer nondurables rose 0.5 percent, led by gains in the production of foods and chemical products; electricity usage and the output of clothing and paper products also increased, but gasoline output fell.

The output of business equipment advanced 0.8 percent; as in August, the increase was concentrated at producers of information processing equipment. The output of industrial equipment was unchanged, and production for this segment remains near its September 1995 level. Led by another large drop in motor vehicle assemblies, the production of transit equipment fell again in September. Growth at commercial aircraft manufacturers continued strong, however, with production up more than 14 percent since June. The output of defense and space equipment edged up in September after having posted substantial increases in the two preceding months. The production of construction supplies, which had risen a revised 0.7 percent in August, increased 0.2 percent; the output of business supplies, however, rebounded from the previous two months of weakness, advancing 1.1 percent.

The output of industrial materials was flat in September. With a return to more seasonal temperatures, the production of energy materials edged up 0.2 percent after having risen 2.4 percent in August. After strong growth in August, the output of durable goods materials was unchanged, as gains in the output of parts destined for use in computer, aviation, and defense equipment were offset by declines in parts used primarily in consumer durables. The output of nondurable materials increased just 0.1 percent after a 0.7 percent decline in August; declines in textile materials and containers largely offset gains in paper, chemical, and miscellaneous materials.

When analyzed by industry group, the data show that after a revised 0.1 percent gain in August, factory output increased 0.2 percent in September; the production of durable goods edged up 0.1 percent, while that of nondurable goods grew 0.5 percent. Among durables, the output of motor vehicles and parts and of miscellaneous manufactures declined substantially; the production of lumber and of iron and steel also fell. These declines were more than offset, however, by substantial increases in computer and office equipment, in aerospace and miscellaneous transportation equipment, and in stone, clay, and glass products and by small increases in other industries. Among nondurables, the indexes for food, tobacco, paper, and chemicals all posted gains in excess of 0.5 percent; printing and publishing and petroleum refining also advanced. On the negative side, the output of leather products, textile mill products, and apparel products, all of which had declined in August, fell again. The production of rubber and plastics products also retreated.

The factory operating rate edged down 0.1 percentage point, to 82.2 percent. The rate for advanced-processing industries decreased 0.2 percentage point, to 80.5 percent, and the rate for primary-processing industries slipped 0.1 percentage point, to 86.2 percent. Although the operating rate for primary processors remains 4 percentage points below the high rate for the current expansion, achieved in December 1994, capacity utilization for these industries is 3.6 percentage points above its 1967–95 average. In particular, the operating rates for primary metals, petroleum refining, fabricated metals products, and rubber and plastics products are more than 5 percentage points above their long-run averages.

This release and the history for all published series are available on the Internet at http://www.bog.frb.fed.us, the Board of Governors World Wide Web site.

1996 Revision Announcement

During the fourth quarter, the Federal Reserve will publish revisions of its measures of industrial production (IP), capacity, capacity utilization, and industrial use of electric power; the current target for publishing the revision is late November. The revisions of IP, capacity, and capacity utilization will incorporate updated source data for recent years and will feature a change in the method of aggregating the indexes. From 1977 onward, the value-added proportions used to weight individual series will be updated annually rather than quinquennially. In addition, the IP indexes and the capacity measures will be rebased so that 1992 actual output equals 100. Capacity utilization, the ratio of IP to capacity, will be recomputed on the basis of revised IP and capacity measures.

The aggregate IP indexes will be constructed with a superlative index formula similar to that introduced by the Bureau of Economic Analysis as the featured measure of real output in its January 1996 comprehensive revision of the National Income and Product Accounts. At present, the aggregate IP indexes are computed as linked Laspeyres indexes, with the weights updated every five years. Because of the rapid fall in the relative price of computers and peripheral equipment, that periodic updating of weights is too infrequent to provide reliable estimates of current changes in output, capacity, and capacity utilization. With the publication of the revision, value-added proportions will be updated annually, and the new index number formula will be applied to all aggregates of IP, capacity, and gross value of product. For the most part, relative price movements among the 260 individual components of the IP index are likely to have little visible effect on total IP. However, the more frequent updating of the relative price of the output of the computer industry could lower overall IP growth in some years by as much as ½ percentage point; in other years, the updating of weights will have virtually no effect. Because the new index number formula will slow capacity growth as well as IP growth, the effect of the reaggregation on overall capacity utilization should be small.

The regular updating of source data for IP will include the introduction of annual data from the *1994 Annual Survey of Manufactures* and selected *1995 Current Industrial Reports* of the Bureau of the Census. Available annual data on mining for 1994 and 1995 from the Department of the Interior will also be introduced. Revisions to the monthly indicators for each industry (physical product data, production-worker hours, or electric power usage) and revised seasonal factors will be incorporated back to 1992. In addition, the benchmark index for semiconductor output will be revised back to 1977 to reflect a hedonic price index similar in concept to that used for the computer industry.

The statistics on the industrial use of electric power will be revised back to 1972. These revisions stem from three basic sources. First, the new figures incorporate more complete reports received from utilities for the past few years. Second, an updated panel of reporters on cogeneration will be fully integrated into our survey of electric power use. Third, the levels of the monthly electric power series for manufacturing industries will be benchmarked to indexes derived from data published in the Census Bureau's annual surveys and censuses of manufactures. These indexes will also be revised so that 1992 electric power usage equals 100.

More detail on the plans for this revision is available on the Internet at http://www.bog.frb.fed.us. Once the revision is published, the revised data will be available at that site and on diskettes from the Board of Governors of the Federal Reserve System, Publications Services, 202-452-3245. The revised data will also be available through the Economic Bulletin Board of the Department of Commerce; call 202-482-1986. In addition to the data currently provided, the time series of implicit prices necessary for a user to aggregate IP and capacity under the new methodology will be provided by the Industrial Output Section, 202-452-3151. □

Statements to the Congress

Statement by Lawrence B. Lindsey, Member, Board of Governors of the Federal Reserve System, before the Committee on Banking and Financial Services, U.S. House of Representatives, September 12, 1996

I am pleased to appear before this committee today to discuss trends in consumer lending; the Federal Reserve Board's view of the likely causes of these developments; and their likely effect on the U.S. economy, banks, and consumers.

As Chairman Leach noted in his letter of invitation, consumer delinquencies on nonmortgage debt have increased in recent periods, and bankruptcy filings could well exceed 1 million in 1996. These developments have begun to affect profit margins at some financial institutions, and the Federal Reserve has been closely monitoring these conditions and discussing their implications with individual banking organizations and industry groups. In our view, given the generally strong financial condition of the institutions most affected by these developments and that of the U.S. banking system, these adverse trends do not currently present a material threat either to individual banking organizations or to the overall banking system.

We have also been carefully monitoring the effect of higher debt levels on the potential for sustained noninflationary growth in the U.S. economy. Although household debt levels are at or near record levels, we believe that the balance sheet of the household sector viewed in the aggregate is sound. Barring unexpected developments in either consumer credit policies or the wealth or income position of households, we do not believe that current debt levels pose a threat to the continuation of the present economic expansion. However, although balance sheets are sound overall, the trends affecting different household groups have been uneven. As a result, we might expect, and are seeing, increased caution on the part of lenders regarding further extensions of credit. Lenders are, and should be, on heightened alert for potential signs of increased financial stress among households.

In my remarks, I would like to begin with an overview of the economic factors that are likely to have contributed to the rising levels of consumer debt. I shall then turn to the emerging—and still well-contained—consequences that these developments are having on the banking organizations that are most affected and on the industry overall. Finally, I shall consider some of the potential economic ramifications of the current levels of consumer debt.

Reasons for Higher Debt Levels

Economic developments in the United States have, in recent years, been favorable to growth in both spending and borrowing by the household sector and to strong growth in consumer lending by U.S. banks, making both supply and demand factors conducive to consumer credit expansion. On the demand side, rising levels of employment and income coupled with the dramatic increases in stock and bond prices, and thus aggregate household wealth, have led to both a greater ability and a greater willingness of consumers to spend.

During this same time period, rates and fees on consumer financing products have been coming down. For example, average credit card rates, which stood at about 18¼ percent in late 1991, declined to less than 15½ percent by May of this year. At the same time, annual fees on credit cards were dropped by many institutions. In addition, declining residential mortgage rates throughout most of this interval contributed to a significant reduction in monthly payments on such debts. The relatively low mortgage rates of the early 1990s precipitated a refinancing boom that allowed many consumers to reduce significantly their monthly mortgage obligations and to pay down higher cost consumer debt.

In combination, these generally favorable developments have given consumers the confidence and financial foundation to incur additional debt to finance major purchases. The net effect is that we have increased our spending faster than we have increased our income. Since the second quarter of 1991, when the present expansion began, real per capita disposable personal income has risen $1,264, while real per capita expenditures have gone up $1,389. Essentially, for every $1.00 our income has gone up, we have spent $1.10. This extra spending has been particularly concentrated among big ticket items, which economists call ‘‘durables.’’ While real spending per capita has risen about 8.5 percent overall, real per capita spending on durables has risen more than three times as fast (27.3 percent). It is not unusual for consumers to borrow to finance these durable purchases. High rates of durable purchases and consumer confidence usually occur during business cycle expansions. So, much of the higher level of consumer debt could be attributed to acquiring additional assets, a normal development at this stage of the business cycle.

The growth in nonmortgage consumer debt has been particularly robust in the past two to three years. As the economy emerged from recession in 1991, growth in nonmortgage consumer debt was much slower than typical, reflecting sluggish spending on durable goods and lingering fears about long-term layoffs and other threats to job security. However, by 1994 consumer confidence had recovered considerably, and demand for autos and other durable goods had strengthened. Nonmortgage consumer debt grew about 15 percent that year and the next. Revolving credit—primarily credit card debt—has been, by far, the fastest-growing component of consumer debt, averaging annual increases of 20 percent over the past two years.

In part, the rapid rise in credit card debt is part of a long-standing trend. In 1977, when first reported separately to the Federal Reserve, revolving debt of U.S. consumers totaled $30 billion, or 14 percent of all consumer debt. In July of this year, the amount outstanding was $454 billion (preliminary), or nearly 40 percent of the total. Some surveys show that 80 percent of U.S. households now have at least one credit card. In addition, some of the increase in consumer debt is merely a reflection of the greater prevalence of convenience use of credit cards as a substitute for cash or check payment. Convenience users typically pay their card balances in full each month. The increased convenience use of credit cards has been reinforced in recent years by a variety of incentives, such as the availability of frequent flier miles. But, the Federal Reserve's Survey of Consumer Finances suggests that the convenience share of outstanding credit card debt, defined as credit extended to people who always pay their credit card bills each month, has not risen markedly in recent years and still accounts only for roughly one dollar in seven of aggregate credit card debt.

The particularly rapid growth in the demand for unsecured credit coupled with changes in both legal and social attitudes raises another potential, albeit disturbing, factor affecting demand: the increased incidence of personal bankruptcy. Late last month, the American Bankruptcy Institute reported that personal bankruptcy filings in the second quarter neared the 300,000 mark and had exceeded 1 million in the previous twelve months for the first time in history. On the basis of available information, it is hard to refute the observation of Sam Gerdano, the head of the institute, that "today's bankruptcy boom is the natural result of three years of sustained consumer spending increases that far outpaced income growth in an era of greater social acceptance of bankruptcy."

A recent survey of the causes of consumer bankruptcy by VISA indicated that being overextended was the most commonly cited reason. Interestingly, it exceeded event-specific reasons such as medical emergencies, unemployment, and divorce.

While rising levels of consumer debt may be contributing to the climb in bankruptcies, bankruptcy law may also be contributing to rising debt levels. Several factors are said to be contributing to higher rates of personal bankruptcy, including greater social acceptability of the practice, changes in law that have made bankruptcy less onerous for individuals, and increased advertising by bankruptcy attorneys. To the extent that bankruptcy is perceived by consumers as an easier option, the demand for credit, and particularly the willingness to take on high levels of credit, is enhanced. With the consequences of bankruptcy reduced, individuals, other things equal, may be more willing to borrow than would otherwise be the case. One may not wish to foreclose the possibility of renewed credit access to those who have been forced by uncontrollable circumstances to seek the protection of bankruptcy, but it should be recognized that undue generosity on this score only encourages greater use of the bankruptcy remedy and consequent chargeoffs.

In sum, a variety of macroeconomic and socioeconomic factors have contributed to the rise in the demand for consumer credit. The lower cost of credit is certainly a factor. Higher income and wealth and the consequent increase in consumer confidence have increased the willingness to both spend and borrow. A long-term trend toward greater willingness to use household debt, particularly credit card debt, has also played a factor. The reduced consequences of personal bankruptcy may also have played a role.

Accompanying the increase in demand for consumer credit have been developments on the supply side of the market. As a percentage of total bank loans, consumer debt (including mortgages) has been increasing steadily for some time—from 33 percent of total bank loans in 1980 to roughly 40 percent five years ago and about 44 percent today. Credit card debt has been a particularly fast growing segment of bank portfolios. Since late in 1991, credit card debt has risen about twice as fast as total loans. If one adds back estimates of the outstanding securitized credit card debt of banks, such credit has risen almost three times as fast as total loans at banks.

The industry's total increase in credit card loans has been supported by the aggressive marketing of some banks. Marketing campaigns typically involve broad-based, regional, or nationwide solicitations and often include preapproved lines of credit based on the results of "credit scoring" models that statistically evaluate an individual's creditworthiness. Credit scoring and computer-based statistical evaluation have sharply lowered the cost of making a decision to extend credit. This has greatly facilitated the mass marketing of credit to individuals who are not bank customers and who live outside banks' traditional service areas.

In addition, banks' success in securitizing consumer debt instruments for resale in capital markets has increased both their willingness and their ability to make such loans. Securitization and credit scoring have necessitated heavy investments in the technological infrastructure needed to evaluate, originate, and effectively manage such credits.

In turn, this has changed the cost structure of the industry to favor an expansion of volume to exploit scale economies. Major competitors have increasingly used special promotions offering reduced fees and rates to obtain market share and maximize the scale economies of their operations. Some have also been willing to take on greater risk in the interest of increasing loan volumes. Such competitive zeal all too often attracts weak or otherwise marginal borrowers. The resultant adverse selection of credit risks has contributed to a decline in asset quality at some banks.

While these problems have eroded returns at individual institutions, a critical factor that continues to contribute to the emphasis on such lending has been the significant, overall long-term profitability of the credit card business. This is not irrelevant for a banking system whose largest institutions had been under earnings pressure through much of the 1980s because of their exposures to developing countries, energy sector borrowers, and commercial real estate markets. Thus, both supply and demand factors help explain the increase in the levels of consumer debt that we have recently experienced.

EFFECT ON THE BANKING SECTOR

One indication of the profitability of credit card lending can be seen in analyzing the so-called credit card banks (defined to include banks with more than $1 billion in assets and with credit card balances comprising more than 50 percent of total assets). For various legal, tax, and operating reasons, most large banking organizations find it convenient to establish such banks, separate from their other operations, as a vehicle for booking most, if not all, of their credit card loans. These roughly thirty entities most recently reported an average annualized return on assets for the second quarter of 2 percent, compared with a quarterly return of 1.3 percent for all insured commercial banks. While credit card banks remained more profitable than other banks, their profitability has declined a good bit in recent years because of heightened competition and the erosion of credit quality. Credit card banks also maintain average equity to asset and loan-loss reserves to total loan ratios well above industry averages.

The strong earnings profiles of the credit card banks, and their associated capital and reserve allocations, are reflections of the risks associated with this form of lending. Higher risk and higher return go hand in hand, and the higher capital and reserves associated with this form of credit are required to balance the risk. Put another way, lenders active in the credit card business are conscious of higher potential loss rates and expect returns that will fully absorb these losses and still provide an adequate profit margin. They are also aware of the necessity to take steps to ensure that the variance in returns on these loans does not create significant solvency concerns for their organizations.

Generally speaking, delinquency rates on nonmortgage consumer loans have been trending up for the past year, with some of the increase in delinquency rates merely the result of the "seasoning" of recently underwritten loans, a typical pattern. However, for credit cards, the widely followed statistics of the American Bankers Association show that the *number* of delinquent accounts is historically high. The more comprehensive figures from the official bank call reports based on the *dollar* volumes of loan balances, however, show a much milder upturn in delinquencies—but still one warranting our attention.

Recently, our supervisory activities, surveys of examiners, and discussions with bankers all have supported the view that banks are recognizing weaknesses in the consumer lending market and are actively adjusting their underwriting and monitoring procedures for these loans. Some banks have also increased their levels of reserves for these loans in recent months.

Since March 1995, the Federal Reserve has also been conducting a quarterly survey of its most senior examiners to track their assessments of conditions in the banking market, including their assessments of any changes in lending terms and conditions for consumer loans. To supplement these surveys, regular discussions are conducted with bankers and supervisory officials at the Reserve Banks to ascertain their opinions on current lending conditions. In the most recent Federal Reserve Senior Loan Officer Survey, nearly half of the respondent banks, on net, had tightened underwriting standards for approving new credit card applications, up from about a quarter in the two previous surveys. More broadly, the proportion of respondents *less* willing to make consumer installment loans slightly exceeded the proportion that was *more* willing to lend, for the first time since 1991. Such a revisiting of current credit standards and practices seems well considered, given the length of the current period of economic expansion and the signs of weakness in some elements of consumer finances such as rising delinquency and bankruptcy rates.

Potential Economic Ramifications

Reduced Willingness To Lend

The survey results on banks' willingness to lend to finance consumer purchases raises a natural macroeconomic question. Could a pullback in bank willingness to lend create potential difficulties for the sustainability of the economic expansion? Figure 1 provides some historical detail on this issue.[1] As the figure indicates, there seems to be a degree of coincidence between pullbacks in banks' willingness to lend and economic downturns. Nonetheless, it would be premature to expect that any current pullback in the willingness to lend to consumers would necessarily precipitate a recession.

First, although the chart does indicate an apparent relationship, it is not at all clear that a cause-and-effect relationship exists or in which direction any economic causality might run. On theoretical grounds, one could argue either that a pullback in credit leads to lower spending and thus to a recession or that recessions produce a deterioration in credit quality that causes banks to be less willing to make further extensions of credit.

Second, as the data on delinquencies and bankruptcies make clear, a good case can be made that reductions in credit are appropriate responses to past excess credit extensions. In this regard, they increase the long-term health and viability of the economic expansion by ending potential economic excesses before they adversely affect the banking and credit delivery system.

Third, the development of computerized credit-scoring models offers the potential for more discerning and carefully targeted reductions in the willingness to extend credit or adjustments in the terms on accounts. In this regard, a reduced willingness to lend may be more narrowly focused than in the past. The adverse impact of a reduction in credit availability might therefore be less in the present expansion than it has been in the past.

Still, the potential for a systematic and widespread pullback in credit access needs careful monitoring. Our first concern is that banks are engaging in safe and sound lending practices. As I mentioned earlier, we believe that they are. Thus, any regulatory or legislative mandate to reduce bank credit extensions to consumers is unnecessary. We also do not believe that the reduced willingness to extend credit at the current time is sufficiently widespread to create any significant macroeconomic risk to the expansion.

Excessive Debt Service Burdens

A second potential economic concern involves high debt-service burdens (that is, the amount a household must pay each month to cover its debt obligations). At some point, one would imagine that the cost of servicing rising levels of debt would absorb such a large chunk of consumers' disposable income that they would have no choice but to reduce current consumption. However, neither economic theory nor empirical evidence provides any good indication of the level at which debt-service constraints begin to reduce spending.

Figure 2 shows the level of estimated debt service as a percentage of disposable personal income over the past thirty years. While high, the current level of debt service payments is not out of the range of past experience. As conventionally measured, the level is now 16.9 percent, up from a cyclical low of 15.3 percent at the end of 1993 but below its peak of 17.6 percent at the end of 1989.

A number of developments have taken place recently that have affected this measure. First, the level of mortgage debt service has fallen by a full percentage point of disposable personal income, from 6.8 percent at the end of 1989 to 5.8 percent currently. This has been partially offset by a higher level of consumer installment debt.

1. The attachment to this statement is available from Publications Services, Mail Stop 127, Board of Governors of the Federal Reserve System, Washington, DC 20551.

Second, the use of auto leasing has expanded rapidly in recent years, in part, acting as a substitute for taking out an installment loan to purchase an automobile. If one adjusts the measure of debt-service burden for leasing, our staff estimates that we would now be about matching the previous peak in the debt-service burden. Since the previous peak at the end of 1989, the effect of auto leasing has more than doubled, raising debt-service payments by more than 1 percent of income currently versus just 0.5 percent of income in late 1989.

The Level and Distribution of Household Debt

The balance sheet of the U.S. household sector, taken as a whole, has improved substantially in recent years. The dramatic increase in the stock market, for example, has increased the financial assets of households by $4.75 trillion since the end of the recession in 1991. Overall, household assets have increased by $9.5 trillion, while household liabilities have risen $1.5 trillion. This rise in aggregate household wealth has doubtless supported the level of consumption spending of recent years and allowed households to increase their consumption faster than their incomes have risen.

From an economic point of view, nothing is wrong with consumers increasing their debt per se. Increasing debt to finance long-term investments, such as housing, durables, or even education, may be prudent depending on one's individual circumstances. Furthermore, taking on debt may be a prudent means of maintaining consumption levels during a period when income is below one's expectations of its long-term trend. As I shall argue later, this may be one reason for higher levels of consumer debt at present.

Suffice it to say that there are good reasons for any individual U.S. family to take on additional debt, and it would be wrong for a Federal Reserve governor to opine that some particular U.S. family is too much in debt. Individuals know their own circumstances far better than any government official. But a look at disaggregated data provides insights into economic trends regarding the willingness of U.S. families to add to their levels of debt.

Figure 3 combines information from the Federal Reserve's Survey of Consumer Finances (SCF) on the distribution of household debt with our estimates from the flow of funds accounts on the debt-to-income ratio of the U.S. household sector.[2] We estimate that, on average, the household sector increased its debt-to-income ratio about 5 percentage points between 1992 and 1995. This was the result of an increase of 2 percentage points in mortgage debt, from 59.8 percent of income to 61.9 percent of income and an increase of 3 percentage points in nonmortgage consumer debt, from 16.9 percent of income to 19.8 percent of income.

Nevertheless, the survey data suggest some interesting trends in the distribution of this debt. Typically, households earning more than $100,000 per year sharply reduced their debt levels between 1992 and 1995. The share of total household debt held by these households fell from one-third to one-quarter, and this decline was particularly concentrated among households earning more than $250,000 per year. These upper income groups experienced a decline in both the mean and median absolute level of debt outstanding, while all other income groups increased their debt.

The decline in the debt levels for these groups makes the rise in debt levels for other groups more striking. For example, households with incomes between $50,000 and $100,000 increased their rates of aggregate mortgage debt to aggregate income by about one-sixth and their corresponding consumer debt to income ratio by roughly 50 percent.

Of course, some households increased their debt substantially more than this, and some not at all. The Survey of Consumer Finances does indicate a striking increase in the willingness to go into debt in the $50,000 to $100,000 income group. The proportion of survey households in this income group reporting credit card debt rose 13 percentage points, from 51 percent in 1992 to 64 percent in 1995, compared with a 4-point increase, from 44 percent to 48 percent for the whole population. Those holding installment debt such as auto loans increased from 52 percent to 59 percent in this income group, while the proportion in the overall population with this type of debt was unchanged. Nearly 60 percent of the total increase in nonmortgage debt outstanding was assumed by households in this income group.

Debt increases for households earning less than $50,000 were also sizable. The increasing attractiveness of various types of financing tied to one's home produced a particularly large increase in the ratio of mortgage debt to income. It should be noted that although the mortgage debt to income ratio increased just 7 percentage points for households earning less than $25,000, compared with 10 percentage points to 11 percentage points for households earning $25,000 to $100,000, homeownership rates are much lower among this segment of the population. Adjusted for

2. The data are from 1992 to 1995 because these are the years in which SCF surveys were conducted.

the lower level of homeownership rates among this income group, mortgage debt to income ratios increased more for these lower income groups than for the $50,000 to $100,000 income group. I might add that the rapid expansion of mortgage financing among low and moderate income groups is borne out by other data as well. We will not know for some time what the overall effect of this lending will be on default and delinquency rates.

But these data also show that while some of the added credit extension during this period is to people in income groups that traditionally have not owed much debt, the bulk is not. While overall debt levels increased for all groups earning less than $100,000, the only group to increase its relative share of such nonmortgage debt was the $50,000 to $100,000 income group. Thus, it is reasonable to conclude that the main reason for the household debt expansion of recent years is not so much an extension of debt to new households but an increase in the debt levels taken on by fairly well-to-do segments of the population to whom being in debt (albeit not at these levels) is not an unusual experience.

From a macroeconomic perspective, we must therefore consider why these middle and upper middle income households have increased their debt levels. Unfortunately, this is the type of question that will only be definitively answered in hindsight. I mentioned one likely explanation earlier. It is not at all unusual for these households to expand their levels of durable purchases and debt to finance these purchases. Consumer confidence is high and up from levels earlier this decade, thus increasing demand. Thus, one possibility is that what we have experienced is a cyclical phenomenon linked to acquisition of consumer durables by relatively affluent households.

A related possibility is that households may be using their access to both mortgage and consumer credit to finance purchases of financial assets. The expectation of high returns in the stock market may have induced some households to borrow to finance these investments. Tax rules regarding both home mortgages and pension plans such as 401(k)s, may have made such purchases of financial assets with debt for which the interest is tax deductible particularly attractive. Whatever the economic performance of such a financial arrangement, consumers are reducing the liquidity of their balance sheets by such actions. I might also add, however, that our most recent Survey of Consumer Finances found little evidence to support this explanation.

Yet another possibility, consistent with both the data and economic theory, is that consumers' long-term confidence is high, but recent experience with earnings has been disappointing. Consumers might be choosing to cover what they perceive as a temporary reduction in their wages from their long-term trend through debt. During the three-year period discussed previously, the increase in wage and salary payments has constituted a smaller share of increased gross domestic product than is usual during expansions. During these three years, increased wage and salary payments constituted only 44 percent of increased GDP, versus 47.2 percent during the 1981–90 period. Stated differently, if wages and salaries constituted the same share of GDP in 1995 as they did in 1990, workers would have enjoyed about $52 billion more in income that year.

Given that overall employment conditions are quite good, workers might reasonably expect this shortfall to be temporary. An economically rational response to this situation would be to borrow temporarily to maintain consumption levels with the expectation that the added debt would be repaid when wages rise to more normal levels. This theory comports with anecdotal concerns about corporate downsizings, which also lend anecdotal support to the sharp debt rise in the $50,000 to $100,000 income group. An open question remains as to whether this wage shortfall is indeed temporary. The comparatively poor performance of labor productivity in recent years is not an encouraging sign. On the other hand, as Chairman Greenspan has noted before this committee, there are reasons to expect that we may not be measuring the impact of new technologies on our economy appropriately.

Thus, we cannot tell for certain what the dominant reasons for the debt increase might be. We cannot tell how the habit of households increasing spending faster than income will break: Will productivity increase to allow wages to constitute more normal portions of GDP, or will consumers ultimately be forced to reduce their spending? Nor can we tell when this current pattern will end. Consumers can probably continue to maintain current spending patterns by increasing their debt levels further for the foreseeable future. The prudence of continuing to do so depends crucially on the household's individual situation.

But at present the Board does not believe that current debt-service levels are a necessary impediment to continued economic expansion. We also see no reason to believe that this expansion of consumer debt on the balance sheets of the Nation's banks is any cause to worry about their underlying safety and soundness. Thus, the Federal Reserve believes that the best policy is to continue to monitor and study developments in this area but that no immediate regulatory or legislative action is warranted.

Statement by Susan M. Phillips, Member, Board of Governors of the Federal Reserve System, before the Committee on Banking and Financial Services, U.S. House of Representatives, September 18, 1996

Thank you for the opportunity to discuss the recent trading losses by Sumitomo Corporation and their implications for U.S. banks and markets. These losses, which relate to copper trading, may be as large as $1.8 billion and once again highlight the importance of sound internal controls by all parties with significant trading activities. At this time the losses appear to be limited to the Sumitomo trading company, which has been meeting all of its obligations to U.S. banks arising from its transactions in the copper market.

In my remarks today, I would like to address the general nature of U.S. bank involvement in trading and financing physical commodity transactions, the Federal Reserve's actions in the immediate aftermath of the announcement of Sumitomo's losses, and the lessons we believe should be drawn from this and similar episodes. In doing so, I would emphasize at the outset that, as a nonfinancial company, the Sumitomo Corporation is not regulated by the Federal Reserve or by any other banking supervisory or regulatory agency in this country or abroad. Consequently, the Federal Reserve's involvement has related principally to reviewing the exposure and role of U.S. banks that lent funds to Sumitomo or that dealt with the company in its copper-related business and to assisting the Commodity Futures Trading Commission (CFTC) in its evaluation of Sumitomo's U.S. activities.

Commodities Trading and Financing Activities of U.S. Banks

U.S. banks have long been involved in financing commodity activities through their agriculture lending programs directed at the production and sale of agricultural products, both domestically and abroad. Indeed, more than one-quarter of all U.S. banks have farm loans in excess of 25 percent of their total loans. Such lending, however, has become less important to our banking system as the relative importance of primary agricultural products in real gross domestic product has declined. At midyear 1996, farm lending accounted for roughly 2.7 percent of total lending by U.S. commercial banks, compared with 5.2 percent in 1970. U.S. banks have also, of course, been active in financing the production, distribution, and sale of many other physical commodities ranging from metals to oil.

Beyond that traditional financing, banks—and, more importantly in this country, nonbank financial institutions—have also participated in agricultural and other commodity markets through their trading of commodity derivatives both on and off organized exchanges. Unlike the banks' more traditional functions, their trading of commodity derivatives has increased in recent years, largely for the same reasons trading activities, in general, have grown: expanded international trade, increased demand for hedging instruments and improved methods for managing and controlling risks, advances in computerization and communications technology, and other factors.

Nevertheless, commodities trading at U.S. banks remains a very small component of their overall activities. Ownership of actual, physical commodities—an activity underlying much of the copper trading of Sumitomo—is generally limited for U.S. banks to gold, silver, and other precious metals. Even their trading of physical commodities contracts on organized exchanges or through privately negotiated transactions is small, accounting for less than 1.0 percent of all their derivatives positions. These contracts, in turn, are about evenly divided between (1) gold and other precious metals and (2) all other commodities.

As you may know, the Sumitomo Corporation has been a major participant in the trading of copper derivatives for many years, largely through the activities of its chief copper trader, Yasuo Hamanaka. Consequently, after indications of problems in the company's copper trading operations, copper prices fell sharply. Copper markets appear to have stabilized, and the Federal Reserve is not aware of any material spillover effects to other markets.

Federal Reserve Actions after Sumitomo's Announcement

Immediately after Sumitomo's announced loss, the Federal Reserve took steps to determine the size and nature of U.S. bank exposures to the trading company and to the copper market. Several banks had trading or financing transactions with Sumitomo relating to its copper trading and were owed payments by Sumitomo in connection with those transactions. Shortly after the announcement, the banks contacted Sumitomo to review and confirm all outstanding transactions relating to copper, and Sumitomo has been meeting all of its obligations as they come due. At this time, any losses appear to be limited to the Sumitomo trading company itself, but it should be noted that the company, regulators, and others are reviewing the events leading to the June announcement.

The Federal Reserve also sought to coordinate its review of U.S. banks' copper-related activities with the CFTC, which was reviewing Sumitomo's conduct. To this end, shortly after the announcement of Sumitomo's loss, senior staff of the Federal Reserve and the CFTC began meeting together to share information pertinent to their respective enquiries. This effort is still ongoing.

Importance of Sound Management Controls

This event highlights, yet again, the importance of a sound management process for controlling risks in both banking and nonbanking organizations. As we have seen time and again in recent years, individual traders today have the capacity to inflict tremendous losses on their institutions when they are allowed to operate in an environment lacking adequate operating procedures and controls. On the other hand, these incidents also illustrate the resilience of even specialized commodities markets and the ability of world markets to absorb dramatic shocks.

It is instructional that the well-publicized losses at Barings, Daiwa, Sumitomo, and others have all derived from violations of fundamental, managerial principles of control, such as those dealing with the recording of all positions and the adequate separation of duties. Managements must build and maintain adequate systems for controlling risks, whether they operate bank or nonbank institutions.

Losses such as Sumitomo's raise the issue of more extensive regulation. Regulation, however, simply cannot substitute for sound management. Earlier episodes clearly demonstrate that the very same problems can occur in regulated as well as unregulated firms and with exchange-traded contracts as well as with privately negotiated contracts. Thus, a more appropriate response—indeed, for nonfinancial companies the only practical response—is to continue to promote policies that foster greater market discipline.

Encouraging greater disclosure of risk levels is an effort that moves in that direction. Disclosures such as an organization's calculated "value-at-risk" have the potential to provide investors and other market participants with greater information regarding the organization's willingness to take risks and are currently being discussed. Official and market pressures to produce such statistics hopefully will continue to strengthen the internal auditing and information systems of many firms. By themselves, though, such quantitative disclosures will not suffice if large exposures are mismeasured or overlooked. Shareholders, boards of directors, and senior managers must absorb the lesson that strong management and control procedures are essential.

In the case of insured commercial banks, the Federal Reserve and the other U.S. federal banking agencies have stressed the need for adequate management processes in dealing with market conditions today and have announced new supervisory procedures to reinforce the point. Through the Bank for International Settlements and other international organizations, both the banking and securities regulatory communities have taken similar steps abroad. These regulatory efforts, combined with the lessons imposed by the markets, should begin to drive home to market practitioners the importance of sound operating procedures and controls.

Conclusion

Although managing and controlling risks in a large organization today can be a complicated, challenging, and expensive task, the costs of *not* adequately controlling risks can be much greater. One must conclude from recent events that some institutions have yet to recognize that fact and take adequate preventive measures. While financial risk-taking is essential to our economy, risks should be taken in an informed and intelligent manner and then only when adequately supported with owners' funds. □

Announcements

Meeting of the Consumer Advisory Council

The Federal Reserve Board's Consumer Advisory Council met on October 24, 1996, in a meeting that was open to the public. The council's function is to advise the Board on the exercise of the Board's responsibilities under the Consumer Credit Protection Act and on other matters on which the Board seeks its advice.

Amendment to Section 20 of the Glass–Steagall Act

The Federal Reserve Board announced on September 11, 1996, that it would adopt a change in the manner in which interest earned on certain securities held by a company in an underwriting or dealing capacity is treated in determining whether the company is engaged principally in underwriting and dealing in securities for purposes of section 20 of the Glass–Steagall Act. The amendment is effective November 12, 1996.

Section 20 of the Glass–Steagall Act prohibits a member bank from being affiliated with any company "engaged principally" in underwriting and dealing in securities that a member bank may not underwrite or deal in (ineligible securities). To ensure compliance with section 20, the Board requires that the revenue a bank holding company subsidiary derives from underwriting and dealing in ineligible securities not exceed 10 percent of the total revenue of the company.

The Board is amending its section 20 orders to specify that interest earned on the types of debt securities that a member bank may hold for its own account shall not be treated as revenue from underwriting or dealing in securities for purposes of section 20. Interest on these securities will continue to be included in total revenue. Section 20 subsidiaries may use this method to compute compliance with the revenue limitation in reports filed with the Board after the effective date.

Regulation B: Revisions to the Official Staff Commentary

The Federal Reserve Board issued on September 27, 1996, revisions to its official staff commentary to Regulation B (Equal Credit Opportunity). The revisions provide guidance on issues the Board has been asked to clarify, including credit scoring and spousal signature rules. Compliance became mandatory after October 31, 1996.

Regulation M: Revisions

The Federal Reserve Board issued on September 27, 1996, its final regulation to simplify and clarify required disclosures for car leasing and other types of consumer lease transactions. This new version of Regulation M (Consumer Leasing) stems from the increased use of automobile leasing over the past several years and the Board's review of the regulation in accordance with its policy of periodically examining its regulations to carry out the purpose of the underlying law more effectively.

The new regulation, which carries out provisions of the Consumer Leasing Act, is effective October 1, 1997, as set by the statute, but voluntary compliance is acceptable at any time before that date.

In general, the revisions to Regulation M accomplish the following:

- Adopt a revised disclosure format, including the segregation of certain disclosures
- Adopt a total of payments disclosure to facilitate comparisons
- Revise the disclosure of costs paid at lease signing to make it easier for a consumer to understand the amounts to be paid and how they are allocated
- Require a mathematical progression that shows how the monthly lease payment is calculated and the relationship of terms such as the "capitalized cost" and the "residual value" of the leased property
- Require narrative warnings about possible charges for terminating a lease early and for excess wear and tear

• Require changes in advertising rules to implement statutory amendments, simplify disclosure requirements, and deter misleading advertising

• Require a disclosure to accompany any percentage rate indicating the limitations of rate information.

The Board will publish an updated proposal to the commentary in mid-November 1996. The proposal will include material that was published for comment in September 1995 (60 FR 48769), and will incorporate guidance contained in the section-by-section discussion that accompanies the final rule. The proposal will also address substantive questions that may be brought to the Board's attention regarding particular aspects of the final rule. Correspondence should be submitted to the Director, Division of Consumer and Community Affairs, Washington, DC 20551, with a reference to Regulation M commentary, no later than October 28, 1996.

Regulation Z: Amendment

The Federal Reserve Board announced on September 16, 1996, the adoption of a final rule amending Regulation Z (Truth in Lending). This new rule was effective October 21, 1996.

The revisions to Regulation Z incorporate changes made by the Truth in Lending Act Amendments of 1995. The amendments establish new creditor-liability rules for closed-end loans secured by real property or dwellings and consummated on or after September 30, 1995. The amendments also clarify how lenders must disclose certain fees connected with mortgage loans.

Also, the Board is publishing a new rule regarding the treatment of fees charged in connection with debt cancellation agreements. The rule is similar to the existing rule for credit insurance premiums and provides for more uniform treatment of these fees.

Broadcast of an Educational Program on Saving and Investing

The Federal Reserve Board and the U.S. Securities and Exchange Commission (SEC) announced on September 13, 1996, their co-sponsorship of an educational program for adults on saving and investing entitled ‘‘It's Your Money.’’

This program will be broadcast nationwide by satellite on Saturday, November 9, at 11 a.m. Central Standard Time. It is the first time that the two regulators have collaborated on a consumer outreach effort of this type and scope.

‘‘It's Your Money’’ is an hour-long seminar that will cover the basics of saving and investing as well as explore smart ways to deal with today's markets. The purpose of the program, which is free of charge, is to encourage saving and to foster a greater understanding of investments. Topics will include the following:

- Budgeting to find money to save
- Using compounding to help your savings grow
- Choosing banking services
- Understanding risk
- Setting goals
- Making investment choices.

The first half of the seminar will focus on saving; the second segment will be devoted to a presentation on how to invest wisely by SEC Chairman Arthur Levitt. A panel composed of the following experts will field questions on both topics:

Alice Rivlin, Vice Chair of the Federal Reserve Board
Kelvin Boston, author of *Smart Money Moves for African Americans*
Thomas Jones, Vice Chairman and President of TIAA-CREF
Beth Kobliner, author of *Get a Financial Life*
Tyler Mathisen, Executive Editor of *Money* magazine
Grace Weinstein, author of *The Lifetime Book of Money Management.*

The moderator of this educational broadcast will be Bob Ray Sanders, columnist for the *Fort Worth Star-Telegram* and the host of ‘‘Between the Lines,’’ a weekly news and public affairs program on KERA-TV, the PBS affiliate in Dallas–Fort Worth.

‘‘It's Your Money’’ is a unique opportunity for financial institutions, securities firms, certified financial planners, and other related industries and groups to offer their clients and communities a program on saving and investing that allows their individual questions to be answered by a renowned panel of experts.

The Federal Reserve Board and the SEC are pleased to have the support of the Alliance for Investor Education, which is a newly formed group of investment industry organizations. The Alliance has been organized to facilitate a greater understanding of investments, investing, and the financial markets.

This program will be broadcast from Westcott Communications in Dallas, Texas, and made available to individuals and groups through Westcott's Interactive Distance Training Network (IDTN) and its other affiliates throughout the country. In addition, the program has been made available to the Community College Satellite Network, with more than 900 community college members. Members of the National University Teleconference Network, a consortium of downlink facilities at colleges and universities, will also have access to this teleseminar.

American Financial Skylink, a subsidiary of the American Bankers Association, will make this teleseminar available to the subscribers of its satellite network in live format on Saturday, November 9, and in videotape format as a special program in December.

If you would like to arrange the broadcast of this teleseminar in your community or to your customers, you can register by calling 1-800-805-9145 or by accessing the Federal Reserve Board's Internet site at http://www.bog.frb.fed.us. For more information about the program, call Marci Schneider at 202-452-3655. □

Minutes of the Federal Open Market Committee Meeting Held on August 20, 1996

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, August 20, 1996, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Boehne
Mr. Jordan
Mr. Kelley
Mr. Lindsey
Mr. McTeer
Mr. Meyer
Ms. Phillips
Ms. Rivlin
Mr. Stern
Ms. Yellen

Messrs. Broaddus, Guynn, Moskow, and Parry, Alternate Members of the Federal Open Market Committee

Messrs. Hoenig, Melzer, and Ms. Minehan, Presidents of the Federal Reserve Banks of Kansas City, St. Louis, and Boston respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Prell, Economist

Messrs. Lang, Lindsey, Mishkin, Promisel, Rolnick, Rosenblum, Siegman, Simpson, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Madigan and Slifman, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors
Ms. Johnson, Assistant Director, Division of International Finance, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors
Mr. Connolly, First Vice President, Federal Reserve Bank of Boston
Mr. Beebe, Ms. Browne, Messrs. Davis, Dewald, Eisenbeis, and Goodfriend, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Boston, Kansas City, St. Louis, Atlanta, and Richmond respectively
Ms. Krieger, Vice President, Federal Reserve Bank of New York
Mr. Sullivan, Assistant Vice President, Federal Reserve Bank of Chicago
Mr. Bryan, Consultant, Federal Reserve Bank of Cleveland

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on July 2–3, 1996, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market transactions in foreign currencies for System account during the period since the meeting on July 2–3, 1996, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in U.S. government securities and federal agency obligations during the period July 3, 1996, through August 20, 1996. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that the economic expansion had moderated somewhat recently. Growth in consumer spending appeared to be slowing, business purchases of equipment and structures were rising less vigorously, and higher mortgage rates were beginning to exert a restraining effect on housing construction. Business inventory accumulation had been quite modest, and production and employment were expanding less rapidly. Increases in labor compensation had been somewhat larger this year, but consumer price inflation, adjusted for food and energy prices, had remained on a fairly steady trend.

Private nonfarm payroll employment increased relatively rapidly in July, though at a considerably slower pace than in the second quarter. Job growth in the services industry slowed sharply, and manufacturing employment declined appreciably after having risen somewhat in the second quarter. In contrast, the expansion in employment in wholesale and retail trade picked up slightly in July, and the number of jobs in construction continued to increase at about the second-quarter pace. The average workweek for private production or nonsupervisory workers fell considerably in July, to a level a little below its average for the second quarter, and the civilian unemployment rate edged up to 5.4 percent.

Industrial production rose slightly further in July after three consecutive months of strong gains; manufacturing production expanded less rapidly, and electricity generation dropped sharply as a result of unseasonably cool weather. A substantial increase in the production of motor vehicles and parts accounted for most of the advance in manufacturing output. Elsewhere, the manufacture of office and computing equipment continued on its strong upward trend in July while the production of other business equipment slipped. The output of consumer goods edged lower after having risen slightly in May and June. The rate of utilization of total industrial capacity declined a little in July but remained at a relatively high level.

Retail sales weakened somewhat over June and July following several months of robust growth. Sales of motor vehicles were down in both months, and spending on other goods rose sluggishly on balance. Housing starts fell somewhat further in July, reflecting a sizable decline in single-family starts that more than offset a bounceback in multifamily starts. The drop in housing starts, coupled with lower sales of new and existing homes in June (latest data available), suggested that the rise in mortgage rates was exerting a damping effect on housing demand and homebuilding activity.

Growth in business spending on durable equipment and nonresidential structures had slowed after a very rapid expansion earlier in the year. Shipments of nondefense capital goods were little changed in June after a sizable increase in May. Weakness in outlays for aircraft more than offset persisting strength in spending on office and computing equipment, and purchases of other types of equipment, notably communications and industrial equipment, continued to advance briskly. Nonresidential construction activity rebounded in June from an appreciable decrease in May. The pace of office building picked up, and construction of other commercial and industrial structures posted healthy gains after May declines.

Business inventories increased by a modest amount in June after having contracted in May. In manufacturing, inventories continued to run off in June, reducing the sector's stock–sales ratio to near its historical low. Wholesale trade stocks also fell in June, and the inventory–sales ratio was in the lower portion of its range over recent years. Retail inventories rose in June; larger stocks at automotive dealers more than accounted for the increase. The inventory–sales ratio for the sector as a whole edged higher but remained at a relatively low level.

The nominal deficit on U.S. trade in goods and services narrowed in June, but on a quarterly average basis the deficit widened in the second quarter from its rate in the first quarter. In June, the value of exports declined slightly, but the value of imports dropped by a considerably larger amount from a relatively high rate in May. Available information suggested that economic activity in the major foreign industrial countries continued to advance, but at an uneven pace; in Germany, activity rebounded from the contraction in the first quarter, while in Japan a considerable slowing of growth had occurred in the second quarter after very rapid expansion in the first quarter.

Price inflation remained moderate on balance in June and July, with declines in energy prices essentially offsetting increases in food prices. Over a somewhat longer horizon, consumer prices for nonfood, non-energy items rose slightly less in the twelve months ended in July than in the previous twelve-month period. Producer prices of finished goods other than food and energy also increased more slowly in the twelve months ended in July. In contrast, growth in labor costs had picked up. The employment cost index for private industry workers advanced at a somewhat faster rate in the second quarter than in the first quarter or in the second half of 1995. Measured over the year ended in June, the index rose by a slightly larger amount than in the previous year.

At its meeting on July 2–3, 1996, the Committee adopted a directive that called for maintaining the existing degree of pressure on reserve positions but that included a bias toward the possible firming of reserve conditions during the intermeeting period. The directive stated that in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would be acceptable and slightly lesser reserve restraint might be acceptable during the intermeeting period. The reserve conditions associated with this directive were expected to be consistent with moderate growth of M2 and M3 over coming months.

With economic growth moderating and inflation quiescent, open market operations were directed toward maintaining the existing degree of pressure on reserve positions throughout the intermeeting period. The federal funds rate averaged a little higher than the level expected with an unchanged policy stance, in part because of unexpectedly high demand for reserves in late July and early August. On balance, most other short-term market interest rates declined slightly, and intermediate- and long-term rates fell somewhat more, over the intermeeting period. In the days immediately following the meeting, rates rose sharply in response to incoming data, notably the employment report for June that market participants viewed as indicating increasing pressures on economic resources and labor costs. Subsequently, however, that rise was more than reversed when further data releases were interpreted as suggesting that the economic expansion might be slowing and that the upturn in labor compensation was mild. Equity prices also exhibited considerable volatility over the period since the Committee meeting on July 2–3, with major indexes of stock prices falling steeply through late July before recouping part to most of their losses in association with the bond market rally and favorable earnings reports.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies declined slightly over the intermeeting period. The flow of information suggesting a slowing in U.S. economic growth and reduced prospects for a near-term tightening of Federal Reserve policy weighed against the dollar. On the other hand, the yen was bolstered by incoming data suggesting that the Japanese current account surplus was again widening, and the German mark benefited from the Bundesbank's inaction at a time when market participants were expecting a policy easing.

Growth of M2 and M3 moderated in July. Much of the slowdown in the expansion of M2 was associated with an unexpected decline in demand deposits, which had grown rapidly earlier in the year. With bank credit expanding sluggishly, the funding needs of banks were modest, and the slower growth of M2 showed through to M3. For the year through July, both aggregates were estimated to have increased at rates somewhat below the upper bounds of their respective ranges for the year. Expansion in total domestic nonfinancial debt had been moderate on balance over recent months and had remained in the middle portion of its range.

The staff forecast prepared for this meeting suggested that the expansion would slow to a rate around, or perhaps a little above, the economy's estimated growth potential. Consumer spending was projected to expand at a more moderate pace that would be in line with the projected increase in disposable income; the favorable effect of the earlier run-up in equity prices on household wealth and the generally ample availability of credit were expected to balance continuing consumer concerns about the adequacy of their savings and the restraining effect of high household debt burdens. Homebuilding was forecast to slow somewhat in response to the backup in residential mortgage rates but to remain at a relatively high level in the context of sustained income growth and the still-favorable cash flow affordability of home ownership. Business spending on equipment and structures was projected to grow less rapidly in light of the anticipated moderate growth of sales and profits. On balance, the external sector was expected to exert a small restraining influence on economic activity over the projection period. Only modest fiscal restraint was anticipated over the forecast horizon. Inflation recently had been lifted by adverse developments in energy markets and was projected to remain above the levels of recent years, given the high level of resource utilization, the effects of tight grain supplies on food prices, and a noticeable step-up in labor compensation reinforced by the legislated rise in the federal minimum wage.

In the Committee's discussion of current and prospective economic developments, members commented that on balance the information received since the July meeting, including anecdotal reports from around the nation, pointed to some slowing in the growth of economic activity from a very rapid pace during the spring. The extent of the slowing remained uncertain, and it was unclear at this juncture whether the expansion would slow sufficiently to contain pressures on labor and other producer resources. Nonetheless, broad measures of price inflation, adjusted to exclude their volatile food and energy components, did not exhibit any uptrend despite robust growth in economic activity this year and high levels of resource use. Indeed, some price measures suggested that inflation had trended lower through the second quarter. Moreover, there were no early signs of pressures or imbalances in the industrial sector. In labor markets, however, there were increasing indications of tightness that might at some point feed through to greater inflation. Upward wage adjustments were becoming more evident and increases in overall compensation had edged up, suggesting the possibility of further increases in labor costs at current or higher levels of labor utilization even before taking account of the effects of the rise in the minimum wage. Although increases in compensation might be moderated by greater productivity or absorbed for a time by lower profit margins, the risks seemed tilted toward increases in inflation at some point, especially if the growth of the economy continued to outstrip its potential and added to pressures on resources.

In the course of the Committee's discussion, members cited a variety of indications that economic growth was slowing from a very rapid pace, and they pointed to a number of factors that in their view should promote continued, though more moderate, expansion in economic activity. These included generally supportive financial conditions, relatively high levels of consumer confidence, and the absence of major imbalances in the economy. It was noted that much of the stimulus for the strong expansion in the first half of the year had been provided by large increases in spending for consumer durables, housing, and business equipment; however, growth in such spending could be expected to slow in the context of increasingly satisfied pent-up demands and the lagged effects of earlier increases in intermediate- and long-term interest rates on these interest-sensitive sectors of the economy. A key uncertainty in the outlook was the prospective behavior of inventories. Should the expansion in final demand fail to moderate to a sustainable pace, business firms would be likely to intensify their efforts to build their inventories, which currently were widely viewed as satisfactory or even relatively lean in relation to sales. While some buildup in inventories appeared to be occurring in the current quarter, developments that might lead to a sharp increase in inventory investment, such as shortages of various goods and materials and lengthening delays in securing deliveries, were not in evidence at this time. Accordingly, aggressive inventory accumulation remained an upside risk to the projected expansion but not one that was likely to materialize unless final demand were to exceed current forecasts by a significant margin.

In their discussion of the outlook for inflation, members observed that increases in prices had remained remarkably subdued for an extended period in relation to measures of resource utilization, notably the rate of unemployment. Such behavior differed markedly from the historical experience under similar circumstances. One factor tending to hold down prices has been highly competitive markets—throughout the nation and internationally as well—that have made it very difficult for business firms to raise prices. Another key factor, though one whose importance might now be starting to diminish, was the persistence of comparatively small increases in labor compensation, which remained appreciably below earlier norms in relation to levels of unemployment. This development appeared to reflect worker concerns about job security in a period of major business restructuring and downsizing activities as well as substantially reduced increases in benefit costs, notably those relating to health care.

In assessing whether a relatively favorable inflation performance was likely to continue, the members focused on a variety of issues. One was whether the expansion would moderate sufficiently to keep pressures on labor and other resources from intensifying. Another was whether a rate of unemployment in the vicinity of its current level would foster added wage pressures. Uncertainty also surrounded the extent to which further increases in labor compensation costs, should they materialize, would be passed through to higher prices. Improvements in productivity were likely to offset part of such increases, but how much remained an open question. In addition, profit margins were high, but the extent to which they might narrow to absorb increasing labor costs was difficult to predict. With regard to the outlook for wages, members observed that, though it was too early to reach a firm judgment, the acceleration of wage increases this year might well augur faster advances that were more in line with historical experience under essentially full employment conditions. Moreover, the tendency toward reduced increases in the costs of benefits might tend to dissipate, though some members commented that further economies in the provision of medical services might well be achievable for some period. On balance, the inflation risks in the outlook clearly seemed to be to the upside, with the potential for more inflation stemming from rising labor compensation costs augmented by a rise in the minimum wage and the prospect of higher food prices and perhaps energy prices over the next several quarters.

In the Committee's discussion of policy for the intermeeting period ahead, members focused on indications that the economy already was slowing, perhaps by enough to limit pressures on resources, and they noted that broad statistical measures of prices and the anecdotal evidence did not suggest that a pickup in inflation was already under way. Consequently, all but one of the members supported a proposal to maintain an unchanged policy stance. A number also commented that real interest rates were not unusually low, suggesting that any pickup in inflationary pressures, should that occur, would be modest and readily contained. One concern was that policy tightening at this point might generate an excessive reaction in financial markets, both because it was not generally expected and because it would represent a change in policy direction that might well lead to expectations of further policy tightening. Such a development could have serious adverse consequences for economic activity if the expansion was in fact already slowing to a more sustainable and less inflationary pace. These members therefore concluded that the prudent course at this point was to await further developments that would permit them to assess the possible need for some tightening with a higher degree of confidence. At the same time, it was emphasized that the Committee remained committed to a policy that would resist a rise in inflation; such a policy would entail moving in anticipation of greater price pressures and before they showed through to actual inflation. Accordingly, they also agreed on the desirability of a directive that remained biased toward possible tightening in the intermeeting period ahead. Such a directive would imply that any tightening should be implemented promptly if developments were perceived as pointing to rising inflation. For now, the Committee should remain particularly vigilant to incoming information bearing on the outlook for inflation.

A differing view gave more weight to the risks of rising inflation. In this view, while there were uncertainties, the weight of the evidence suggested that a prompt policy action was needed to contain inflation and set the stage for further progress toward price stability. The possibility of an overreaction in financial markets to a tightening move could not be ruled out, but such a reaction was likely to be short-lived. More importantly, a prompt action would reduce the risk that inflation would worsen and pose difficult problems for monetary policy later.

At the conclusion of the Committee's discussion, all but one member indicated that they supported a directive that called for maintaining the existing degree of pressure on reserve positions and that included a bias toward the possible firming of reserve conditions during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that somewhat greater reserve restraint would be acceptable and slightly lesser reserve restraint might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with moderate growth of M2 and M3 over coming months.

At the conclusion of the meeting, the Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that growth in economic activity recently has moderated somewhat. Private nonfarm payroll employment grew less rapidly in July, the average workweek fell sharply, and the civilian unemployment rate edged up to 5.4 percent. Industrial production increased slightly in July after three months of strong gains. Real consumer spending weakened somewhat on balance over June and July following several months of robust growth. Housing starts fell somewhat further in July. Growth in spending on business equipment and nonresidential structures has slowed after a very rapid expansion earlier in the year. The nominal deficit on U.S. trade in goods and services widened in the second quarter from its rate in the first quarter. Increases in labor compensation have been somewhat larger this year, but consumer price inflation, adjusted for food and energy prices, has remained on a fairly steady trend.

Most short-term market interest rates have declined slightly while intermediate- and long-term rates have fallen somewhat more since the Committee meeting on July 2–3, 1996. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies has depreciated slightly over the intermeeting period.

Growth of M2 and M3 moderated in July. For the year through July, both aggregates are estimated to have grown at rates somewhat below the upper bounds of their respective ranges for the year. Expansion in total domestic nonfinancial debt has been moderate on balance over recent months and has remained in the middle portion of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in July reaffirmed the ranges it had established in January for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1995 to the fourth quarter of 1996. The monitoring range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1997 the Committee agreed on a tentative basis to set the same ranges as in 1996 for growth of the monetary aggregages and debt, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with moderate growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Boehne, Jordan, Kelley, Lindsey, McTeer, Meyer, Mses. Phillips, Rivlin, and Yellen. Vote against this action: Mr. Stern.

Mr. Stern dissented because he believed that policy should become modestly more restrictive. He was concerned that, in the absence of a substantial and sustained improvement in productivity, the prevailing pattern of demand might engender an increase in inflationary pressures, and that such pressures would ultimately threaten the ongoing economic expansion. In Mr. Stern's judgment, it was prudent at this point to resist such a development in order to lay a foundation for the long-term health of the economy.

It was agreed that the next meeting of the Committee would be held on Tuesday, September 24, 1996.

The meeting adjourned at 12:45 p.m.

Donald L. Kohn
Secretary

Legal Developments

Final Rule—Amendment to Regulation B

The Board of Governors is amending 12 C.F.R. Part 202, its official staff commentary to Regulation B (Equal Credit Opportunity). The commentary applies and interprets the requirements of Regulation B and substitutes for individual staff interpretations. The revisions to the commentary provide guidance on issues that the Board has been asked to clarify, including credit scoring and spousal signature rules.

Effective September 30, 1996, 12 C.F.R. Part 202 is amended as follows:

Part 202—Equal Credit Opportunity (Regulation B)

1. The authority citation for Part 202 continues to read as follows:

Authority: 15 U.S.C. 1691-1691f.

2. In Supplement I to Part 202, under *Section 202.2 Definitions,* under *2(p) Empirically derived and other credit scoring systems.,* four new sentences are added at the end of paragraph 2 to read as follows:

Supplement I to Part 202—Official Staff Interpretations

* * * * *

Section 202.2—Definitions

* * * * *

2(p) Empirically derived and other credit scoring systems.

* * * * *

2. * * * To ensure that predictive ability is being maintained, creditors must periodically review the performance of the system. This could be done, for example, by analyzing the loan portfolio to determine the delinquency rate for each score interval, or by analyzing population stability over time to detect deviations of recent applications from the applicant population used to validate the system. If this analysis indicates that the system no longer predicts risk with statistical soundness, the system must be adjusted as necessary to reestablish its predictive ability. A creditor is responsible for ensuring its system is validated and revalidated based on the creditor's own data when it becomes available.

* * * * *

3. In Supplement I to Part 202, under *Section 202.5 Rules Concerning Taking of Applications,* under *5(e) Written applications.,* paragraph 3 is revised to read as follows:

* * * * *

Section 202.5—Rules Concerning Taking of Applications

* * * * *

5(e) Written applications.

* * * * *

3. *Computerized entry.* Information entered directly into and retained by a computerized system qualifies as a written application under this paragraph. (See the commentary to section 202.13(b), *Applications through electronic media* and *Applications through video*.)

* * * * *

4. In Supplement I to Part 202, under *Section 202.6 Rules Concerning Evaluation of Applications,* under paragraph 6(b)(2), paragraph 2 is revised; paragraphs 4 and 5 are redesignated as paragraphs 5 and 6, respectively; and new paragraph 4 is added to read as follows:

* * * * *

Section 202.6—Rules Concerning Evaluation of Applications

* * * * *

Paragraph 6(b)(2)

* * * * *

2. *Consideration of age in a credit scoring system.* Age may be taken directly into account in a credit scoring system that is "demonstrably and statistically sound," as defined in section 202.2(p), with one limitation: applicants 62 years or older must be treated at least as favorably as applicants who are under 62. If age is scored by assigning points to an applicant's age category, elderly applicants must receive the same or a greater number of points as the most favored class of nonelderly applicants.

i. *Age-split scorecards.* A creditor may segment the population into scorecards based on the age of an applicant. In such a system, one card covers a narrow age range (for example, applicants in their twenties or younger) who are evaluated under attributes predictive for that age group. A second card covers all other applicants who are evaluated under the attributes predictive for that broad class. When a system uses a card covering a wide age range that encompasses elderly applicants, the credit scoring system does not score age. Thus, the system does not raise the issue of assigning a negative factor or value to the age of elderly applicants. But if a system segments the population by age into multiple scorecards, and includes elderly applicants in a narrower age range, the credit scoring system does score age. To comply with the act and regulation in such a case, the creditor must ensure that the system does not assign a negative factor or value to the age of elderly applicants as a class.

* * * * *

4. *Consideration of age in a reverse mortgage.* A reverse mortgage is a home-secured loan in which the borrower receives payments from the creditor, and does not become obligated to repay these amounts (other than in the case of default) until the borrower dies, moves permanently from the home or transfers title to the home, or upon a specified maturity date. Disbursements to the borrower under a reverse mortgage typically are determined by considering the value of the borrower's home, the current interest rate, and the borrower's life expectancy. A reverse mortgage program that requires borrowers to be age 62 or older is permissible under section 202.6(b)(2)(iv). In addition, under section 202.6(b)(2)(iii), a creditor may consider a borrower's age to evaluate a pertinent element of creditworthiness, such as the amount of the credit or monthly payments that the borrower will receive, or the estimated repayment date.

* * * * *

5. In Supplement I to Part 202, *Section 202.7—Rules Concerning Extensions of Credit,* is amended as follows:

a. Under Paragraph 7(d)(2), paragraph 1. is revised; and

b. Paragraph 7(d)(6) is revised.

The revisions read as follows:

* * * * *

Section 202.7—Rules Concerning Extensions of Credit

* * * * *

Paragraph 7(d)(2)

1. *Jointly owned property.* If an applicant requests unsecured credit, does not own sufficient separate property, and relies on joint property to establish creditworthiness, the creditor must value the applicant's interest in the jointly owned property. A creditor may not request that a nonapplicant joint owner sign any instrument as a condition of the credit extension unless the applicant's interest does not support the amount and terms of the credit sought.

i. *Valuation of applicant's interest.* In determining the value of an applicant's interest in jointly owned property, a creditor may consider factors such as the form of ownership and the property's susceptibility to attachment, execution, severance, or partition; the value of the applicant's interest after such action; and the cost associated with the action. This determination must be based on the form of ownership prior to or at consummation, and not on the possibility of a subsequent change. For example, in determining whether a married applicant's interest in jointly owned property is sufficient to satisfy the creditor's standards of creditworthiness for individual credit, a creditor may not consider that the applicant's separate property may be transferred into tenancy by the entirety after consummation. Similarly, a creditor may not consider the possibility that the couple may divorce. Accordingly, a creditor may not require the signature of the nonapplicant spouse in these or similar circumstances.

ii. *Other options to support credit.* If the applicant's interest in jointly owned property does not support the amount and terms of credit sought, the creditor may offer the applicant other options to provide additional support for the extension of credit. For example—

A. Requesting an additional party (*see* section 202.7(d)(5));

B. Offering to grant the applicant's request on a secured basis (*see* section 202.7(d)(4)); or

C. Asking for the signature of the joint owner on an instrument that ensures access to the property in the event of the applicant's death or default, but does not impose personal liability unless necessary under state law (*e.g.,* a limited guarantee). A creditor may not routinely require, however, that a joint owner sign an instrument (such as a quitclaim deed) that would result in the forfeiture of the joint owner's interest in the property.

* * * * *

Paragraph 7(d)(6)

1. *Guarantees.* A guarantee on an extension of credit is part of a credit transaction and therefore subject to the regulation. A creditor may require the personal guarantee of the partners, directors, or officers of a business, and the shareholders of a closely held corporation, even if the business or corporation is creditworthy. The requirement must be based on the guarantor's relationship with the business or corporation, however, and not on a prohibited basis. For example, a creditor may not require guarantees only for women-owned or minority-owned businesses. Similarly, a creditor may not require guarantees only from the married officers of a business or married shareholders of a closely held corporation.

2. *Spousal guarantees.* The rules in section 202.7(d) bar a creditor from requiring a signature of a *guarantor's spouse* just as they bar the creditor from requiring the signature of an *applicant's spouse.* For example, although a creditor may require all officers of a closely held corporation to personally guarantee a corporate loan, the creditor may not automatically require that

spouses of married officers also sign the guarantee. If an evaluation of the financial circumstances of an officer indicates that an additional signature is necessary, however, the creditor may require the signature of a spouse in appropriate circumstances in accordance with section 202.7(d)(2).

6. In Supplement I to Part 202, *Section 202.13—Information for Monitoring Purposes*, is amended as follows:

a. Under *13(a) Information to be requested.*, paragraph 6 is revised; and

b. Under *13(b) Obtaining of information.*, paragraphs 4 and 5 are redesignated as paragraphs 6 and 7, respectively, and new paragraphs 4 and 5 are added.

The revisions and additions are to read as follows:

* * * * *

Section 202.13 Information for Monitoring purposes

13(a) Information to be requested.

* * * * *

6. *Refinancings.* A refinancing occurs when an existing obligation is satisfied and replaced by a new obligation undertaken by the same borrower. A creditor that receives an application to refinance an existing extension of credit made by that creditor for the purchase of the applicant's dwelling may request the monitoring information again but is not required to do so if it was obtained in the earlier transaction.

* * * * *

13(b) Obtaining of information.

* * * * *

4. *Applications through electronic media.* If an applicant applies through an electronic medium (for example, the Internet or a facsimile) without video capability that allows the creditor to see the applicant, the creditor may treat the application as if it were received by mail or telephone.

5. *Applications through video.* If a creditor takes an application through a medium that allows the creditor to see the applicant, the creditor treats the application as taken in person and must note the monitoring information on the basis of visual observation or surname, if the applicant chooses not to provide the information.

* * * * *

Final Rule—Amendment to Regulation M

The Board of Governors is amending 12 C.F.R. Part 213, its Regulation M (Consumer Leasing). The Consumer Leasing Act requires lessors to provide uniform cost and other disclosures about consumer lease transactions. The Board has reviewed Regulation M, pursuant to its policy of periodically reviewing its regulations, and has revised the regulation to carry out more effectively the purposes of the Act. The final rule adds disclosures, primarily in connection with motor vehicle leasing, including, for example, disclosures about early termination charges and how scheduled payments are derived (which requires disclosure of such items as the gross capitalized cost of a lease, the vehicle's residual value, the rent charge, and depreciation). General changes in the format of the disclosures require that certain leasing disclosures be segregated from other information. Revisions to the advertising provisions implement a statutory amendment, allowing a toll-free number to substitute for certain disclosures in radio and television advertisements, and make other changes to the advertising rules. A lessor is not required to disclose the cost of a lease expressed as a percentage rate; however, if a rate is disclosed or advertised, a special notice must accompany the rate. Further, a rate in an advertisement cannot be more prominent than any other Regulation M disclosure.

Effective October 31, 1996, 12 C.F.R. Part 213 is amended as follows:

Part 213—Consumer Leasing (Regulation M)

1. The authority citation for Part 213 continues to read as follows:

Authority: 15 U.S.C. 1604.

2. The table of contents to Part 213 is revised to read as follows:

Section

213.1 Authority, scope, purpose, and enforcement.
213.2 Definitions.
213.3 General disclosure requirements.
213.4 Content of disclosures.
213.5 Renegotiations, extensions, and assumptions.
213.6 [Reserved]
213.7 Advertising.
213.8 Record retention.
213.9 Relation to state laws.
Appendix A to Part 213 — Model Forms
Appendix B to Part 213 — Federal Enforcement Agencies
Appendix C to Part 213 — Issuance of Staff Interpretations
Supplement I to Part 213 — Official Staff Commentary to Regulation M

3. Part 213 is amended as follows:

a. Sections 213.1 through 213.5 are revised;
b. Section 213.6 is removed and reserved;
c. Sections 213.7 and 213.8 are revised;
d. Section 213.9 is added;
e. Appendices A through C are revised; and,
f. Appendix D is removed.

The revisions and additions read as follows:

Section 213.1—Authority, scope, purpose, and enforcement.

(a) *Authority.* The regulation in this part, known as Regulation M, is issued by the Board of Governors of the Federal Reserve System to implement the consumer leasing provisions of the Truth in Lending Act, which is Title I of the Consumer Credit Protection Act, as amended (15 U.S.C. 1601 *et seq*.).

(b) *Scope and purpose.* This part applies to all persons that are lessors of personal property under consumer leases as those terms are defined in sections 213.2(e)(1) and (h). The purpose of this part is:

(1) To ensure that lessees of personal property receive meaningful disclosures that enable them to compare lease terms with other leases and, where appropriate, with credit transactions;

(2) To limit the amount of balloon payments in consumer lease transactions; and

(3) To provide for the accurate disclosure of lease terms in advertising.

(c) *Enforcement and liability.* Section 108 of the act contains the administrative enforcement provisions. Sections 112, 130, 131, and 185 of the act contain the liability provisions for failing to comply with the requirements of the act and this part.

Section 213.2—Definitions.

For the purposes of this part the following definitions apply:

(a) *Act* means the Truth in Lending Act (15 U.S.C. 1601 *et seq.*) and the Consumer Leasing Act is chapter 5 of the Truth In Lending Act.

(b) *Advertisement* means a commercial message in any medium that directly or indirectly promotes a consumer lease transaction.

(c) *Board* refers to the Board of Governors of the Federal Reserve System.

(d) *Closed-end lease* means a consumer lease other than an open-end lease as defined in this section.

(e)(1) *Consumer lease* means a contract in the form of a bailment or lease for the use of personal property by a natural person primarily for personal, family, or household purposes, for a period exceeding four months and for a total contractual obligation not exceeding $25,000, whether or not the lessee has the option to purchase or otherwise become the owner of the property at the expiration of the lease. Unless the context indicates otherwise, in this part ‘‘lease’’ means ‘‘consumer lease.’’

(2) The term does not include a lease that meets the definition of a credit sale in Regulation Z (12 C.F.R. 226.2(a)). It also does not include a lease for agricultural, business, or commercial purposes or a lease made to an organization.

(3) This part does not apply to a lease transaction of personal property which is incident to the lease of real property and which provides that:

(i) The lessee has no liability for the value of the personal property at the end of the lease term except for abnormal wear and tear, and

(ii) The lessee has no option to purchase the leased property.

(f) *Gross capitalized cost* means the amount agreed upon by the lessor and the lessee as the value of the leased property and any items that are capitalized or amortized during the lease term, including but not limited to taxes, insurance, service agreements, and any outstanding balance from a prior loan or lease. *Capitalized cost reduction* means the total amount of any rebate, cash payment, net trade-in allowance, and noncash credit that reduces the gross capitalized cost. The *adjusted capitalized cost* equals the gross capitalized cost less the capitalized cost reduction, and is the amount used by the lessor in calculating the base periodic payment.

(g) *Lessee* means a natural person who enters into or is offered a consumer lease.

(h) *Lessor* means a person who regularly leases, offers to lease, or arranges for the lease of personal property under a consumer lease. A person who has leased, offered, or arranged to lease personal property more than five times in the preceding calendar year or more than five times in the current calendar year is subject to the act and this part.

(i) *Open-end lease* means a consumer lease in which the lessee's liability at the end of the lease term is based on the difference between the residual value of the leased property and its realized value.

(j) *Organization* means a corporation, trust, estate, partnership, cooperative, association, or government entity or instrumentality.

(k) *Person* means a natural person or an organization.

(l) *Personal property* means any property that is not real property under the law of the state where the property is located at the time it is offered or made available for lease.

(m) *Realized value* means:

(1) The price received by the lessor for the leased property at disposition;

(2) The highest offer for disposition of the leased property; or

(3) The fair market value of the leased property at the end of the lease term.

(n) *Residual value* means the value of the leased property at the end of the lease term, as estimated or assigned at consummation by the lessor, used in calculating the base periodic payment.

(o) *Security interest* and *security* mean any interest in property that secures the payment or performance of an obligation.

(p) *State* means any state, the District of Columbia, the Commonwealth of Puerto Rico, and any territory or possession of the United States.

Section 213.3—General disclosure requirements.

(a) *General requirements.* A lessor shall make the disclosures required by section 213.4, as applicable. The disclosures shall be made clearly and conspicuously in writing in a form the consumer may keep, in accordance with this section.

(1) *Form of disclosures.* The disclosures required by section 213.4 shall be given to the lessee together in a dated statement that identifies the lessor and the lessee; the disclosures may be made either in a separate statement that identifies the consumer lease transaction or in the contract or other document evidencing the lease. Alternatively, the disclosures required to be segregated from other information under paragraph (a)(2) of this section may be provided in a separate dated statement that identifies the lease, and the other required disclosures may be provided in the lease contract or other document evidencing the lease. In a lease of multiple items, the property description required by section 213.4(a) may be given in a separate statement that is incorporated by reference in the disclosure statement required by this paragraph.

(2) *Segregation of certain disclosures.* The following disclosures shall be segregated from other information and shall contain only directly related information: sections 213.4(b) through (f), (g)(2), (h)(3), (i)(1), (j), and (m)(1). The headings, content, and format for the disclosures referred to in this paragraph (a)(2) shall be provided in a manner substantially similar to the applicable model form in appendix A of this part.

(3) *Timing of disclosures.* A lessor shall provide the disclosures to the lessee prior to the consummation of a consumer lease.

(4) *Language of disclosures.* The disclosures required by section 213.4 may be made in a language other than English provided that they are made available in English upon the lessee's request.

(b) *Additional information; nonsegregated disclosures.* Additional information may be provided with any disclosure not listed in paragraph (a)(2) of this section, but it shall not be stated, used, or placed so as to mislead or confuse the lessee or contradict, obscure, or detract attention from any disclosure required by this part.

(c) *Multiple lessors or lessees.* When a transaction involves more than one lessor, the disclosures required by this part may be made by one lessor on behalf of all the lessors. When a lease involves more than one lessee, the lessor may provide the disclosures to any lessee who is primarily liable on the lease.

(d) *Use of estimates.* If an amount or other item needed to comply with a required disclosure is unknown or unavailable after reasonable efforts have been made to ascertain the information, the lessor may use a reasonable estimate that is based on the best information available to the lessor, is clearly identified as an estimate, and is not used to circumvent or evade any disclosures required by this part.

(e) *Effect of subsequent occurrence.* If a required disclosure becomes inaccurate because of an event occurring after consummation, the inaccuracy is not a violation of this part.

(f) *Minor variations.* A lessor may disregard the effects of the following in making disclosures:

(1) That payments must be collected in whole cents;

(2) That dates of scheduled payments may be different because a scheduled date is not a business day;

(3) That months have different numbers of days; and

(4) That February 29 occurs in a leap year.

Section 213.4—Content of disclosures.

For any consumer lease subject to this part, the lessor shall disclose the following information, as applicable:

(a) *Description of property.* A brief description of the leased property sufficient to identify the property to the lessee and lessor.

(b) *Amount due at lease signing.* The total amount to be paid prior to or at consummation, using the term "amount due at lease signing." The lessor shall itemize each component by type and amount, including any refundable security deposit, advance monthly or other periodic payment, and capitalized cost reduction; and in motor-vehicle leases, shall itemize how the amount due will be paid, by type and amount, including any net trade-in allowance, rebates, noncash credits, and cash payments in a format substantially similar to the model forms in Appendix A of this part.

(c) *Payment schedule and total amount of periodic payments.* The number, amount, and due dates or periods of payments scheduled under the lease, and the total amount of the periodic payments.

(d) *Other charges.* The total amount of other charges payable to the lessor, itemized by type and amount, that are not included in the periodic payments. Such charges include the amount of any liability the lease imposes upon the lessee at the end of the lease term; the potential difference between the residual and realized values referred to in paragraph (k) of this section is excluded.

(e) *Total of payments.* The total of payments, with a description such as "the amount you will have paid by the end of the lease." This amount is the sum of the amount due at lease signing (less any refundable amounts), the total amount of periodic payments (less any portion of the periodic payment paid at lease signing), and other charges under paragraphs (b), (c), and (d) of this section. In an open-end lease, a description such as "you will owe an additional amount if the actual value of the vehicle is less than the residual value" shall accompany the disclosure.

(f) *Payment calculation.* In a motor-vehicle lease, a mathematical progression of how the scheduled periodic payment is derived, in a format substantially similar to the applicable model form in Appendix A of this part, which shall contain the following:

(1) *Gross capitalized cost.* The gross capitalized cost, including a disclosure of the agreed upon value of the vehicle, a description such as "the agreed upon value of the vehicle [state the amount] and any items you pay for over the lease term (such as service contracts, insurance, and any outstanding prior loan or lease balance)," and a statement of the lessee's option to receive a separate written itemization of the gross capitalized cost. If requested by the lessee, the itemization shall be provided before consummation.

(2) *Capitalized cost reduction.* The capitalized cost reduction, with a description such as ''the amount of any net trade-in allowance, rebate, noncash credit, or cash you pay that reduces the gross capitalized cost.''

(3) *Adjusted capitalized cost.* The adjusted capitalized cost, with a description such as ''the amount used in calculating your base [periodic] payment.''

(4) *Residual value.* The residual value, with a description such as ''the value of the vehicle at the end of the lease used in calculating your base [periodic] payment.''

(5) *Depreciation and any amortized amounts.* The depreciation and any amortized amounts, which is the difference between the adjusted capitalized cost and the residual value, with a description such as ''the amount charged for the vehicle's decline in value through normal use and for any other items paid over the lease term.''

(6) *Rent charge.* The rent charge, with a description such as ''the amount charged in addition to the depreciation and any amortized amounts.'' This amount is the difference between the total of the base periodic payments over the lease term minus the depreciation and any amortized amounts.

(7) *Total of base periodic payments.* The total of base periodic payments with a description such as ''depreciation and any amortized amounts plus the rent charge.''

(8) *Lease term.* The lease term with a description such as ''the number of [periods of repayment] in your lease.''

(9) *Base periodic payment.* The total of the base periodic payments divided by the number of payment periods in the lease.

(10) *Itemization of other charges.* An itemization of any other charges that are part of the periodic payment.

(11) *Total periodic payment.* The sum of the base periodic payment and any other charges that are part of the periodic payment.

(g) *Early termination.* (1) *Conditions and disclosure of charges.* A statement of the conditions under which the lessee or lessor may terminate the lease prior to the end of the lease term; and the amount or a description of the method for determining the amount of any penalty or other charge for early termination, which must be reasonable.

(2) *Early-termination notice.* In a motor-vehicle lease, a notice substantially similar to the following: ''Early Termination. You may have to pay a substantial charge if you end this lease early. *The charge may be up to several thousand dollars.* The actual charge will depend on when the lease is terminated. The earlier you end the lease, the greater this charge is likely to be.''

(h) *Maintenance responsibilities.* The following provisions are required:

(1) *Statement of responsibilities.* A statement specifying whether the lessor or the lessee is responsible for maintaining or servicing the leased property, together with a brief description of the responsibility;

(2) *Wear and use standard.* A statement of the lessor's standards for wear and use (if any), which must be reasonable; and

(3) *Notice of wear and use standard.* In a motor-vehicle lease, a notice regarding wear and use substantially similar to the following: ''Excessive Wear and Use. You may be charged for excessive wear based on our standards for normal use.'' The notice shall also specify the amount or method for determining any charge for excess mileage.

(i) *Purchase option.* A statement of whether or not the lessee has the option to purchase the leased property, and:

(1) *End of lease term.* If at the end of the lease term, the purchase price; and

(2) *During lease term.* If prior to the end of the lease term, the purchase price or the method for determining the price and when the lessee may exercise this option.

(j) *Statement referencing nonsegregated disclosures.* A statement that the lessee should refer to the lease documents for additional information on early termination, purchase options and maintenance responsibilities, warranties, late and default charges, insurance, and any security interests, if applicable.

(k) *Liability between residual and realized values.* A statement of the lessee's liability, if any, at early termination or at the end of the lease term for the difference between the residual value of the leased property and its realized value.

(l) *Right of appraisal.* If the lessee's liability at early termination or at the end of the lease term is based on the realized value of the leased property, a statement that the lessee may obtain, at the lessee's expense, a professional appraisal by an independent third party (agreed to by the lessee and the lessor) of the value that could be realized at sale of the leased property. The appraisal shall be final and binding on the parties.

(m) *Liability at end of lease term based on residual value.* If the lessee is liable at the end of the lease term for the difference between the residual value of the leased property and its realized value:

(1) *Rent and other charges.* The rent and other charges, paid by the lessee and required by the lessor as an incident to the lease transaction, with a description such as ''the total amount of rent and other charges imposed in connection with your lease [state the amount].''

(2) *Excess liability.* A statement about a rebuttable presumption that, at the end of the lease term, the residual value of the leased property is unreasonable and not in good faith to the extent that the residual value exceeds the realized value by more than three times the base monthly payment (or more than three times the average payment allocable to a monthly period, if the lease calls for periodic payments other than monthly); and that the lessor cannot collect the excess amount unless the lessor brings a successful court action and pays the lessee's reasonable attorney's fees, or unless the excess of the residual value over the realized value is due to unreasonable or excessive wear or use of the leased property (in which case the rebuttable presumption does not apply).

(3) *Mutually agreeable final adjustment.* A statement that the lessee and lessor are permitted, after termination of the lease, to make any mutually agreeable final adjustment regarding excess liability.

(n) *Fees and taxes.* The total dollar amount for all official and license fees, registration, title, or taxes required to be paid to the lessor in connection with the lease.

(o) *Insurance.* A brief identification of insurance in connection with the lease including:

(1) *Voluntary insurance.* If the insurance is provided by or paid through the lessor, the types and amounts of coverage and the cost to the lessee; or

(2) *Required insurance.* If the lessee must obtain the insurance, the types and amounts of coverage required of the lessee.

(p) *Warranties or guarantees.* A statement identifying all express warranties and guarantees from the manufacturer or lessor with respect to the leased property that apply to the lessee.

(q) *Penalties and other charges for delinquency.* The amount or the method of determining the amount of any penalty or other charge for delinquency, default, or late payments, which must be reasonable.

(r) *Security interest.* A description of any security interest, other than a security deposit disclosed under paragraph (b) of this section, held or to be retained by the lessor; and a clear identification of the property to which the security interest relates.

(s) *Limitations on rate information.* If a lessor provides a percentage rate in an advertisement or in documents evidencing the lease transaction, a notice stating that ''this percentage may not measure the overall cost of financing this lease'' shall accompany the rate disclosure. The lessor shall not use the term ''annual percentage rate,'' ''annual lease rate,'' or any equivalent term.

Section 213.5—Renegotiations, extensions, and assumptions.

(a) *Renegotiation*. A renegotiation occurs when a consumer lease subject to this part is satisfied and replaced by a new lease undertaken by the same consumer. A renegotiation requires new disclosures, except as provided in paragraph (d) of this section.

(b) *Extension*. An extension is a continuation, agreed to by the lessor and the lessee, of an existing consumer lease beyond the originally scheduled end of the lease term, except when the continuation is the result of a renegotiation. An extension that exceeds six months requires new disclosures, except as provided in paragraph (d) of this section.

(c) *Assumption*. New disclosures are not required when a consumer lease is assumed by another person, whether or not the lessor charges an assumption fee.

(d) *Exceptions*. New disclosures are not required for the following, even if they meet the definition of a renegotiation or an extension:

(1) A reduction in the lease charge;

(2) The deferment of one or more payments, whether or not a fee is charged;

(3) The extension of a lease for not more than six months on a month-to-month basis or otherwise;

(4) A substitution of leased property with property that has a substantially equivalent or greater economic value, provided no other lease terms are changed;

(5) The addition, deletion, or substitution of leased property in a multiple-item lease, provided the average periodic payment does not change by more than 25 percent; or

(6) An agreement resulting from a court proceeding.

Section 213.6—[Reserved]

Section 213.7—Advertising.

(a) *General rule.* An advertisement for a consumer lease may state that a specific lease of property at specific amounts or terms is available only if the lessor usually and customarily leases or will lease the property at those amounts or terms.

(b) *Clear and conspicuous standard.* Disclosures required by this section shall be made clearly and conspicuously.

(1) *Amount due at lease signing.* Except for the statement of a periodic payment, any affirmative or negative reference to a charge that is a part of the total amount due at lease signing under paragraph (d)(2)(ii) of this section, such as the amount of any capitalized cost reduction (or no capitalized cost reduction is required), shall not be more prominent than the disclosure of the total amount due at lease signing.

(2) *Advertisement of a lease rate.* If a lessor provides a percentage rate in an advertisement, the rate shall not be more prominent than any of the disclosures in section 213.4, with the exception of the notice in section 213.4(s) required to accompany the rate; and the lessor shall not use the term ''annual percentage rate,'' ''annual lease rate,'' or equivalent term.

(c) *Catalogs and multipage advertisements.* A catalog or other multipage advertisement that provides a table or schedule of the required disclosures shall be considered a single advertisement if, for lease terms that appear without all the required disclosures, the advertisement refers to the page or pages on which the table or schedule appears.

(d) *Advertisement of terms that require additional disclosure.*

(1) *Triggering terms.* An advertisement that states any of the following items shall contain the disclosures required by paragraph (d)(2) of this section, except as provided in paragraphs (e) and (f) of this section:

(i) The amount of any payment;

(ii) The number of required payments; or

(iii) A statement of any capitalized cost reduction or other payment required prior to or at consummation, or that no payment is required.

(2) *Additional terms.* An advertisement stating any item listed in paragraph (d)(1) of this section shall also state the following items:

(i) That the transaction advertised is a lease;

(ii) The total amount due at lease signing, or that no payment is required;

(iii) The number, amounts, due dates or periods of scheduled payments, and total of such payments under the lease;

(iv) A statement of whether or not the lessee has the option to purchase the leased property, and where the lessee has the option to purchase at the end of the lease term, the purchase-option price. The method of determining the purchase-option price may be substituted in disclosing the lessee's option to purchase the leased property prior to the end of the lease term;

(v) A statement of the amount, or the method for determining the amount, of the lessee's liability (if any) at the end of the lease term; and

(vi) A statement of the lessee's liability (if any) for the difference between the residual value of the leased property and its realized value at the end of the lease term.

(e) *Alternative disclosures—merchandise tags.* A merchandise tag stating any item listed in paragraph (d)(1) of this section may comply with paragraph (d)(2) of this section by referring to a sign or display prominently posted in the lessor's place of business that contains a table or schedule of the required disclosures.

(f) *Alternative disclosures—television or radio advertisements.*

(1) *Toll-free number or print advertisement.* An advertisement made through television or radio stating any item listed in paragraph (d)(1) of this section complies with paragraph (d)(2) of this section if the advertisement states the items listed in paragraphs (d)(2)(i) through (iii) of this section, and:

(i) Lists a toll-free telephone number along with a reference that such number may be used by consumers to obtain the information required by paragraph (d)(2) of this section; or

(ii) Directs the consumer to a written advertisement in a publication of general circulation in the community served by the media station, including the name and the date of the publication, with a statement that information required by paragraph (d)(2) of this section is included in the advertisement. The written advertisement shall be published beginning at least three days before and ending at least ten days after the broadcast.

(2) *Establishment of toll-free number.*

(i) The toll-free telephone number shall be available for no fewer than ten days, beginning on the date of the broadcast.

(ii) The lessor shall provide the information required by paragraph (d)(2) of this section orally, or in writing upon request.

Section 213.8—Record retention.

A lessor shall retain evidence of compliance with the requirements imposed by this part, other than the advertising requirements under section 213.7, for a period of not less than two years after the date the disclosures are required to be made or an action is required to be taken.

Section 213.9—Relation to state laws.

(a) *Inconsistent state law.* A state law that is inconsistent with the requirements of the act and this part is preempted to the extent of the inconsistency. If a lessor cannot comply with a state law without violating a provision of this part, the state law is inconsistent within the meaning of section 186(a) of the act and is preempted, unless the state law gives greater protection and benefit to the consumer. A state, through an official having primary enforcement or interpretative responsibilities for the state consumer leasing law, may apply to the Board for a preemption determination.

(b) *Exemptions.* (1) *Application.* A state may apply to the Board for an exemption from the requirements of the act and this part for any class of lease transactions within the state. The Board will grant such an exemption if the Board determines that:

(i) The class of leasing transactions is subject to state law requirements substantially similar to the act and this part or that lessees are afforded greater protection under state law; and

(ii) There is adequate provision for state enforcement.

(2) *Enforcement and liability.* After an exemption has been granted, the requirements of the applicable state law (except for additional requirements not imposed by federal law) will constitute the requirements of the act and this part. No exemption will extend to the civil liability provisions of sections 130, 131, and 185 of the act.

Appendix A to Part 213—Model Forms

A-1 Model Open-End or Finance Vehicle Lease Disclosures

A-2 Model Closed-End or Net Vehicle Lease Disclosures

A-3 Model Furniture Lease Disclosures

Appendix A-1 Model Open-End or Finance Vehicle Lease Disclosures

Federal Consumer Leasing Act Disclosures

Date ____________________

Lessor(s) ____________________ **Lessee(s)** ____________________

Amount Due at Lease Signing	**Monthly Payments**	**Other Charges** (not part of your monthly payment)	**Total of Payments** (The amount you will have paid by the end of the lease)
(Itemized below)* $ ____________	Your first monthly payment of $ ____________ is due on ____________, followed by ______ payments of $ ________ due on the ________ of each month. The total of your monthly payments is $ ____________.	Disposition fee (if you do not purchase the vehicle) $ ________ [Annual tax] ________ ____________ ________ Total $ ________	$ ____________ You will owe an additional amount if the actual value of the vehicle is less than the residual value.

*** Itemization of Amount Due at Lease Signing**

Amount Due At Lease Signing:		**How the Amount Due at Lease Signing will be paid:**	
Capitalized cost reduction	$ ________	Net trade-in allowance	$ ________
First monthly payment	________	Rebates and noncash credits	________
Refundable security deposit	________	Amount to be paid in cash	________
Title fees	________		
Registration fees	________		
____________	________		
Total	$ ________	Total	$ ________

Your monthly payment is determined as shown below:

Gross capitalized cost. The agreed upon value of the vehicle ($ ____________) and any items you pay over the lease term (such as service contracts, insurance, and any outstanding prior loan or lease balance)	$	________
If you want an itemization of this amount, please check this box. ☐		
Capitalized cost reduction. The amount of any net trade-in allowance, rebate, noncash credit, or cash you pay that reduces the gross capitalized cost	–	________
Adjusted capitalized cost. The amount used in calculating your base monthly payment	=	________
Residual value. The value of the vehicle at the end of the lease used in calculating your base monthly payment	–	________
Depreciation and any amortized amounts. The amount charged for the vehicle's decline in value through normal use and for other items paid over the lease term	=	________
Rent charge. The amount charged in addition to the depreciation and any amortized amounts	+	________
Total of base monthly payments. The depreciation and any amortized amounts plus the rent charge	=	________
Lease term. The number of months in your lease	÷	________
Base monthly payment	=	________
Monthly sales/use tax	+	________
____________	+	________
Total monthly payment	=$	________

Rent and other charges. The total amount of rent and other charges imposed in connection with your lease $ ____________ .

Early Termination. You may have to pay a substantial charge if you end this lease early. <u>The charge may be up to several thousand dollars</u>. The actual charge will depend on when the lease is terminated. The earlier you end the lease, the greater this charge is likely to be.

Excessive Wear and Use. You may be charged for excessive wear based on our standards for normal use [and for mileage in excess of __________ miles per year at the rate of ________ per mile].

Purchase Option at End of Lease Term. [You have an option to purchase the vehicle at the end of the lease term for $ ____________ [and a purchase option fee of $ ________________].] [You do not have an option to purchase the vehicle at the end of the lease term.]

Other Important Terms. See your lease documents for additional information on early termination, purchase options and maintenance responsibilities, warranties, late and default charges, insurance, and any security interest, if applicable.

Appendix A-1 Model Open-End or Finance Vehicle Lease Disclosures

[The following provisions are the nonsegregated disclosures required under Regulation M.]

Official Fees and Taxes. The total amount you will pay for official and license fees, registration, title, and taxes over the term of your lease, whether included with your monthly payments or assessed otherwise: $________________ .

Insurance. The following types and amounts of insurance will be acquired in connection with this lease:
____ .

_________ We (lessor) will provide the insurance coverage quoted above for a total premium cost of $________________.

_________ You (lessee) agree to provide insurance coverage in the amount and types indicated above.

End of Term Liability. (a) The residual value ($ ______________) of the vehicle is based on a reasonable, good faith estimate of the value of the vehicle at the end of the lease term. If the actual value of the vehicle at that time is greater than the residual value, you will have no further liability under this lease, except for other charges already incurred [and are entitled to a credit or refund of any surplus.] If the actual value of the vehicle is less than the residual value, you will be liable for any difference up to $ _________________ (3 times the monthly payment). For any difference in excess of that amount, you will be liable only if:
1. Excessive use or damage [as described in paragraph ____] [representing more than normal wear and use] resulted in an unusually low value at the end of the term.
2. The matter is not otherwise resolved and we win a lawsuit against you seeking a higher payment.
3. You voluntarily agree with us after the end of the lease term to make a higher payment.

Should we bring a lawsuit against you, we must prove that our original estimate of the value of the leased property at the end of the lease term was reasonable and was made in good faith. For example, we might prove that the actual was less than the original estimated value, although the original estimate was reasonable, because of an unanticipated decline in value for that type of vehicle. We must also pay your attorney's fees.
(b) If you disagree with the value we assign to the vehicle, you may obtain, at your own expense, from an independent third party agreeable to both of us, a professional appraisal of the ____________ value of the leased vehicle which could be realized at sale. The appraised value shall then be used as the actual value.

Standards for Wear and Use. The following standards are applicable for determining unreasonable or excess wear and use of the leased vehicle:
____ .

Maintenance.
[You are responsible for the following maintenance and servicing of the leased vehicle:
____].

[We are responsible for the following maintenance and servicing of the leased vehicle:
____].

Warranties. The leased vehicle is subject to the following express warranties:
____ .

Early Termination and Default. (a) You may terminate this lease before the end of the lease term under the following conditions:
____ .

The charge for such early termination is:
____ .

(b) We may terminate this lease before the end of the lease term under the following conditions:
____ .

Upon such termination we shall be entitled to the following charge(s) for:
____ .

(c) To the extent these charges take into account the value of the vehicle at termination, if you disagree with the value we assign to the vehicle, you may obtain, at your own expense, from an independent third party agreeable to both of us, a professional appraisal of the ___________________ value of the leased vehicle which could be realized at sale. The appraised value shall then be used as the actual value.

Security Interest. We reserve a security interest of the following type in the property listed below to secure performance of your obligations under this lease:
____ .

Late Payments. The charge for late payments is: ____ .

Option to Purchase Leased Property Prior to the End of the Lease. [You have an option to purchase the leased vehicle prior to the end of the term. The price will be [$ _______________________ /[the method of determining the price].] [You do not have an option to purchase the leased vehicle.]

Appendix A-2 Model Closed-End or Net Vehicle Lease Disclosures

Federal Consumer Leasing Act Disclosures

Date ____________________

Lessor(s) ____ **Lessee(s)** ____

Amount Due at Lease Signing	**Monthly Payments**	**Other Charges** (not part of your monthly payment)	**Total of Payments** (The amount you will have paid by the end of the lease)
(Itemized below)* $ ____________	Your first monthly payment of $ __________ is due on __________________, followed by ______ payments of $ _________ due on the ________ of each month. The total of your monthly payments is $ __________.	Disposition fee (if you do not purchase the vehicle) $ __________ [Annual tax] __________ ______________ __________ Total $ __________	$ ______________

*** Itemization of Amount Due at Lease Signing**

Amount Due At Lease Signing:		**How the Amount Due at Lease Signing will be paid:**	
Capitalized cost reduction	$ __________	Net trade-in allowance	$ __________
First monthly payment	__________	Rebates and noncash credits	__________
Refundable security deposit	__________	Amount to be paid in cash	__________
Title fees	__________		
Registration fees	__________		
______________	__________		
Total	$ __________	Total	$ __________

Your monthly payment is determined as shown below:

Gross capitalized cost. The agreed upon value of the vehicle ($_______________) and any items you pay over the lease term (such as service contracts, insurance, and any outstanding prior loan or lease balance) .... $ __________

If you want an itemization of this amount, please check this box. ☐

Capitalized cost reduction. The amount of any net trade-in allowance, rebate, noncash credit, or cash you pay that reduces the gross capitalized cost	–	__________
Adjusted capitalized cost. The amount used in calculating your base monthly payment	=	__________
Residual value. The value of the vehicle at the end of the lease used in calculating your base monthly payment	–	__________
Depreciation and any amortized amounts. The amount charged for the vehicle's decline in value through normal use and for other items paid over the lease term	=	__________
Rent charge. The amount charged in addition to the depreciation and any amortized amounts	+	__________
Total of base monthly payments. The depreciation and any amortized amounts plus the rent charge	=	__________
Lease term. The number of months in your lease	÷	__________
Base monthly payment	=	__________
Monthly sales/use tax	+	__________
______________	+	__________
Total monthly payment	=$	__________

Early Termination. You may have to pay a substantial charge if you end this lease early. <u>The charge may be up to several thousand dollars</u>. The actual charge will depend on when the lease is terminated. The earlier you end the lease, the greater this charge is likely to be.

Excessive Wear and Use. You may be charged for excessive wear based on our standards for normal use [and for mileage in excess of _________ miles per year at the rate of _______ per mile].

Purchase Option at End of Lease Term. [You have an option to purchase the vehicle at the end of the lease term for $ __________ [and a purchase option fee of $ ______________].] [You do not have an option to purchase the vehicle at the end of the lease term.]

Other Important Terms. See your lease documents for additional information on early termination, purchase options and maintenance responsibilities, warranties, late and default charges, insurance, and any security interest, if applicable.

Appendix A-2 Model Closed-End or Net Vehicle Lease Disclosures

[The following provisions are the nonsegregated disclosures required under Regulation M.]

Official Fees and Taxes. The total amount you will pay for official and license fees, registration, title, and taxes over the term of your lease, whether included with your monthly payments or assessed otherwise: $________________ .

Insurance. The following types and amounts of insurance will be acquired in connection with this lease:
____ .

_________ We (lessor) will provide the insurance coverage quoted above for a total premium cost of $ _________________.

_________ You (lessee) agree to provide insurance coverage in the amount and types indicated above.

Standards for Wear and Use. The following standards are applicable for determining unreasonable or excess wear and use of the leased vehicle:
____ .

Maintenance.
[You are responsible for the following maintenance and servicing of the leased vehicle:
____].

[We are responsible for the following maintenance and servicing of the leased vehicle:
____].

Warranties. The leased vehicle is subject to the following express warranties:
____ .

Early Termination and Default. (a) You may terminate this lease before the end of the lease term under the following conditions:
____ .

The charge for such early termination is:
____ .

(b) We may terminate this lease before the end of the lease term under the following conditions:
____ .

Upon such termination we shall be entitled to the following charge(s) for:
____ .

(c) To the extent these charges take into account the value of the vehicle at termination, if you disagree with the value we assign to the vehicle, you may obtain, at your own expense, from an independent third party agreeable to both of us, a professional appraisal of the ___________________ value of the leased vehicle which could be realized at sale. The appraised value shall then be used as the actual value.

Security Interest. We reserve a security interest of the following type in the property listed below to secure performance of your obligations under this lease:
____ .

Late Payments. The charge for late payments is: ____ .

Option to Purchase Leased Property Prior to the End of the Lease. [You have an option to purchase the leased vehicle prior to the end of the term. The price will be [$ _______________________ /[the method of determining the price].] [You do not have an option to purchase the leased vehicle.]

Appendix A-3 Model Furniture Lease Disclosures

Federal Consumer Leasing Act Disclosures

Date ____________________

Lessor(s) ______________________________ **Lessee(s)** ______________________________

Description of Leased Property				
Item	Color	Stock #	Mfg.	Quantity

Amount Due at Lease Signing	**Monthly Payments**	**Other Charges** (not part of your monthly payment)	**Total of Payments** (The amount you will have paid by the end of the lease)
First monthly payment $ ________ Refundable security deposit $ ________ Delivery/Installation fee $ ________ __________________ $ ________ Total $ ________	Your first monthly payment of $ _____________ is due on ____________________, followed by ______ payments of $ ___________ due on the _________ of each month. The total of your monthly payments is $ _____________.	Pick-up fee $ _________ _________ $ _________ Total $ _________	$ ________________

Purchase Option at End of Lease Term. [You have an option to purchase the leased property at the end of the lease term for $ _________ [and a purchase option fee of $ ______________].] [You do not have an option to purchase the leased property at the end of the lease term.]

Other Important Terms. See your lease documents for additional information on early termination, purchase options and maintenance responsibilities, warranties, late and default charges, insurance, and any security interest, if applicable.

[The following provisions are the nonsegregated disclosures required under Regulation M.]

Official Fees and Taxes. The total amount you will pay for official fees, and taxes over the term of your lease, whether included with your monthly payments or assessed otherwise: $ _________________ .

Insurance. The following types and amounts of insurance will be acquired in connection with this lease: ____.

______ We (lessor) will provide the insurance coverage quoted above for a total premium cost of $ _________________ .

______ You (lessee) agree to provide insurance coverage in the amount and types indicated above.

Standards for Wear and Use. The following standards are applicable for determining unreasonable or excess wear and use of the leased property:
____

Maintenance.

[You are responsible for the following maintenance and servicing of the leased property:
____.]

[We are responsible for the following maintenance and servicing of the leased property:
____.]

Warranties. The leased property is subject to the following express warranties:
____.

Early Termination and Default. (a) You may terminate this lease before the end of the lease term under the following conditions:
____.

The charge for such early termination is: ____.

(b) We may terminate this lease before the end of the lease term under the following conditions: ______________________________.

Upon such termination we shall be entitled to the following charge(s) for: ______________________________.

Early Termination and Default. (continued)

(c) To the extent these charges take into account the value of the leased property at termination, if you disagree with the value we assign to the property, you may obtain, at your own expense, from an independent third party agreeable to both of us, a professional appraisal of the ______________ value of the property which could be realized at sale. The appraised value shall then be used as the actual value.

Security Interest. We reserve a security interest of the following type in the property listed below to secure performance of your obligations under this lease: ____.

Late Payments. The charge for late payments is: ____.

Purchase Option Prior to the End of the Lease Term.

[You have an option to purchase the leased property prior to the end of the term. The price will be [$ _________]/the method of determining the price].]

[You do not have an option to purchase the leased property.]

Appendix B to Part 213—Federal Enforcement Agencies

The following list indicates which federal agency enforces Regulation M (12 C.F.R. Part 213) for particular classes of business. Any questions concerning compliance by a particular business should be directed to the appropriate enforcement agency. Terms that are not defined in the Federal Deposit Insurance Act (12 U.S.C. 1813(s)) shall have the meaning given to them in the International Banking Act of 1978 (12 U.S.C. 3101).

1. *National banks and federal branches and federal agencies of foreign banks*

   District office of the Office of the Comptroller of the Currency for the district in which the institution is located.

2. *State member banks, branches and agencies of foreign banks (other than federal branches, federal agencies, and insured state branches of foreign banks), commercial lending companies owned or controlled by foreign banks, and organizations operating under section 25 or 25A of the Federal Reserve Act*

   Federal Reserve Bank serving the District in which the institution is located.

3. *Nonmember insured banks and insured state branches of foreign banks*

   Federal Deposit Insurance Corporation Regional Director for the region in which the institution is located.

4. *Savings institutions insured under the Savings Association Insurance Fund of the FDIC and federally chartered savings banks insured under the Bank Insurance Fund of the FDIC (but not including state-chartered savings banks insured under the Bank Insurance Fund)*

   Office of Thrift Supervision regional director for the region in which the institution is located.

5. *Federal credit unions*

   Regional office of the National Credit Union Administration serving the area in which the federal credit union is located.

6. *Air carriers*

   Assistant General Counsel for Aviation Enforcement and Proceedings, Department of Transportation, 400 Seventh Street, S.W., Washington, DC 20590

7. *Those subject to Packers and Stockyards Act*

   Nearest Packers and Stockyards Administration area supervisor.

8. *Federal Land Banks, Federal Land Bank Associations, Federal Intermediate Credit Banks, and Production Credit Associations*

   Farm Credit Administration, 490 L'Enfant Plaza, S.W., Washington, DC 20578

9. *All other lessors (lessors operating on a local or regional basis should use the address of the FTC regional office in which they operate)*

   Division of Credit Practices, Bureau of Consumer Protection, Federal Trade Commission, Washington, DC 20580

Appendix C to Part 213—Issuance of Staff Interpretations

Officials in the Board's Division of Consumer and Community Affairs are authorized to issue official staff interpretations of this Regulation M (12 C.F.R. Part 213). These interpretations provide the formal protection afforded under section 130(f) of the act. Except in unusual circumstances, interpretations will not be issued separately but will be incorporated in an official commentary to Regulation M (Supplement I of this part), which will be amended periodically. No staff interpretations will be issued approving lessor's forms, statements, or calculation tools or methods.

4. The Supplement to Part 213 is amended by revising the heading to read as follows:

Supplement I to Part 213—Official Staff Commentary to Regulation M

Final Rule—Amendment to Regulation Z

The Board of Governors is amending 12 C.F.R. Part 226, its Regulation Z (Truth in Lending). The revisions implement the Truth in Lending Act Amendments of 1995, which establish new creditor-liability rules for closed-end loans secured by real property or dwellings and consummated on or after September 30, 1995. The 1995 Amendments create several tolerances for accuracy in disclosing the amount of the finance charge, and creditors have no civil or administrative liability if the finance charge and affected disclosures are within the applicable tolerances. The amendments also clarify how lenders must disclose certain fees connected with mortgage loans. In addition, the Board is publishing a new rule regarding the treatment of fees charged in connection with debt cancellation agreements, which is similar to the existing rule for credit insurance premiums and provides for more uniform treatment of these fees.

Effective October 21, 1996, 12 C.F.R. Part 226 is amended as follows:

Part 226—Truth in Lending (Regulation Z)

1. The authority citation for Part 226 continues to read as follows:

Authority: 12 U.S.C. 3806; 15 U.S.C. 1604 and 1637(c)(5).

2. Section 226.2 is amended by revising paragraph (a)(6) to read as follows:

Section 226.2—Definitions and rules of construction.

(a) *Definitions.* * * *

* * * * *

(6) *Business day* means a day on which the creditor's offices are open to the public for carrying on substantially all of its business functions. However, for purposes of rescission under sections 226.15 and 226.23, and for purposes of section 226.31, the term means all calendar days except Sundays and the legal public holidays specified in 5 U.S.C. 6103(a), such as New Year's Day, the Birthday of Martin Luther King, Jr., Washington's Birthday, Memorial Day, Independence Day, Labor Day, Columbus Day, Veterans Day, Thanksgiving Day, and Christmas Day.

* * * * *

3. Section 226.4 is amended as follows:

a. Paragraph (a) is revised;

b. New paragraph (b)(10) is added;

c. A heading is added to paragraph (c)(7), the introductory text to paragraph (c)(7) is republished, paragraphs (c)(7)(ii) and (c)(7)(iii) are revised, paragraph (c)(7)(iv) is redesignated as paragraph (c)(7)(v) and republished, and a new paragraph (c)(7)(iv) is added;

d. The paragraph (d) heading is revised, the paragraph (d)(1) heading and introductory text are revised, paragraph (d)(1)(i) is revised, and a new paragraph (d)(3) is added.

e. A new paragraph (e)(3) is added.

The revisions and additions are to read as follows:

Section 226.4—Finance charge.

(a) *Definition.* The finance charge is the cost of consumer credit as a dollar amount. It includes any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit. It does not include any charge of a type payable in a comparable cash transaction.

(1) *Charges by third parties.* The finance charge includes fees and amounts charged by someone other than the creditor, unless otherwise excluded under this section, if the creditor:

(i) Requires the use of a third party as a condition of or an incident to the extension of credit, even if the consumer can choose the third party; or

(ii) Retains a portion of the third-party charge, to the extent of the portion retained.

(2) *Special rule; closing agent charges.* Fees charged by a third party that conducts the loan closing (such as a settlement agent, attorney, or escrow or title company) are finance charges only if the creditor:

(i) Requires the particular services for which the consumer is charged;

(ii) Requires the imposition of the charge; or

(iii) Retains a portion of the third-party charge, to the extent of the portion retained.

(3) *Special rule; mortgage broker fees.* Fees charged by a mortgage broker (including fees paid by the consumer directly to the broker or to the creditor for delivery to the broker) are finance charges even if the creditor does not require the consumer to use a mortgage broker and even if the creditor does not retain any portion of the charge.

(b) *Example of finance charge* * * *

* * * * *

(10) *Debt cancellation fees.* Charges or premiums paid for debt cancellation coverage written in connection with a credit transaction, whether or not the debt cancellation coverage is insurance under applicable law.

(c) *Charges excluded from the finance charge.* * * *

* * * * *

(7) *Real-estate related fees.* The following fees in a transaction secured by real property or in a residential mortgage transaction, if the fees are bona fide and reasonable in amount:

* * * * *

(ii) Fees for preparing loan-related documents, such as deeds, mortgages, and reconveyance or settlement documents.

(iii) Notary and credit report fees.

(iv) Property appraisal fees or fees for inspections to assess the value or condition of the property if the service is performed prior to closing, including fees related to pest infestation or flood hazard determinations.

(v) Amounts required to be paid into escrow or trustee accounts if the amounts would not otherwise be included in the finance charge.

* * * * *

(d) *Insurance and debt cancellation coverage.* (1) *Voluntary credit insurance premiums.* Premiums for credit life, accident, health or loss-of-income insurance may be excluded from the finance charge if the following conditions are met:

(i) The insurance coverage is not required by the creditor, and this fact is disclosed in writing.

* * * * *

(3) *Voluntary debt cancellation fees.* (i) Charges or premiums paid for debt cancellation coverage of the type specified in paragraph (d)(3)(ii) of this section may be excluded from the finance charge, whether or not the coverage is insurance, if the following conditions are met:

(A) The debt cancellation agreement or coverage is not required by the creditor, and this fact is disclosed in writing;

(B) The fee or premium for the initial term of coverage is disclosed. If the term of coverage is less than the term of the credit transaction, the term of coverage also shall be disclosed. The fee or premium may be disclosed on a unit-cost basis only in open-end credit transactions, closed-end credit transactions by mail or telephone under section 226.17(g), and certain closed-end credit transactions involving a debt cancellation agreement that limits the total amount of indebtedness subject to coverage;

(C) The consumer signs or initials an affirmative written request for coverage after receiving the disclosures specified in this paragraph. Any consumer in the transaction may sign or initial the request.

(ii) Paragraph(d)(3)(i) of this section applies to fees paid for debt cancellation coverage that provides for cancellation of all or part of the debtor's liability for amounts exceeding the value of the collateral securing the obligation, or in the event of the loss of life, health, or income or in case of accident.

(e) *Certain security interest charges.* * * *

* * * * *

(3) *Taxes on security instruments.* Any tax levied on security instruments or on documents evidencing indebtedness if the payment of such taxes is a requirement for recording the instrument securing the evidence of indebtedness.

* * * * *

4. Section 226.17 is amended as follows:
a. In paragraph (a)(1), footnote 38 is revised;
b. Paragraph (c)(2) is redesignated as paragraph (c)(2)(i) and revised, and paragraph (c)(2)(ii) is added;
c. Paragraph (f) is revised.
The revisions and additions are to read as follows:

Section 226.17—General disclosure requirements.

(a) *Form of disclosures.* (1) * * * [38] * * *

* * * * *

(c) *Basis of disclosures and use of estimates.* * * *

(2)(i) If any information necessary for an accurate disclosure is unknown to the creditor, the creditor shall make the disclosure based on the best information reasonably available at the time the disclosure is provided to the consumer, and shall state clearly that the disclosure is an estimate.

(ii) For a transaction in which a portion of the interest is determined on a per-diem basis and collected at consummation, any disclosure affected by the per-diem interest shall be considered accurate if the disclosure is based on the information known to the creditor at the time that the disclosure documents are prepared for consummation of the transaction.

* * * * *

(f) *Early disclosures.* If disclosures required by this subpart are given before the date of consummation of a transaction and a subsequent event makes them inaccurate, the creditor shall disclose before consummation:[39]

(1) Any changed term unless the term was based on an estimate in accordance with section 226.17(c)(2) and was labelled an estimate;

(2) All changed terms, if the annual percentage rate at the time of consummation varies from the annual percentage rate disclosed earlier by more than 1/8 of 1 percentage point in a regular transaction, or more than 1/4 of 1 percentage point in an irregular transaction, as defined in section 226.22(a).

* * * * *

5. Section 226.18 is amended as follows:
a. Footnote 41 in paragraph (d) is removed and paragraph (d) introductory text is republished;
b. New paragraphs (d)(1) and (d)(2) are added;
c. Footnotes 39 and 40 in paragraph (c) are redesignated as footnotes 40 and 41 respectively; and
d. Paragraph (n) is revised.
The revisions and additions are to read as follows:

Section 226.18—Content of disclosures.

* * * * *

(d) *Finance charge.* The *finance charge,* using that term, and a brief description such as ''the dollar amount the credit will cost you.''

(1) *Mortgage loans.* In a transaction secured by real property or a dwelling, the disclosed finance charge and other disclosures affected by the disclosed finance charge (including the amount financed and the annual percentage rate) shall be treated as accurate if the amount disclosed as the finance charge:

(i) Is understated by no more than $100; or

(ii) Is greater than the amount required to be disclosed.

(2) *Other credit.* In any other transaction, the amount disclosed as the finance charge shall be treated as accurate if, in a transaction involving an amount financed of $1,000 or less, it is not more than $5 above or below the amount required to be disclosed; or, in a transaction involving an amount financed of more than $1,000, it is not more than $10 above or below the amount required to be disclosed.

* * * * *

(n) *Insurance and debt cancellation.* The items required by section 226.4(d) in order to exclude certain insurance premiums and debt cancellation fees from the finance charge.

* * * * *

38. The following disclosures may be made together with or separately from other required disclosures: the creditor's identity under section 226.18(a), the variable rate example under section 226.18(f)(4), insurance or debt cancellation under section 226.18(n), and certain security interest charges under section 226.18(o).

39. The following disclosures may be made together with or separately from other required disclosures: the creditor's identity under section 226.18(a), the variable rate example under section 226.18(f)(4), insurance or debt cancellation under section 226.18(n), and certain security interest charges under section 226.18(o).

6. Section 226.19 is amended by revising paragraph (a)(2) to read as follows:

Section 226.19—Certain residential mortgage and variable-rate transactions.

(a) * * *

(2) *Redisclosure required.* If the annual percentage rate at the time of consummation varies from the annual percentage rate disclosed earlier by more than 1/8 of 1 percentage point in a regular transaction or more than 1/4 of 1 percentage point in an irregular transaction, as defined in section 226.22, the creditor shall disclose all the changed terms no later than consummation or settlement.

* * * * *

7. Section 226.22 is amended by adding new paragraphs (a)(4) and (a)(5) to read as follows:

Section 226.22—Determination of annual percentage rate.

(a) *Accuracy of annual percentage rate.* * * *

* * * * *

(4) *Mortgage loans.* If the annual percentage rate disclosed in a transaction secured by real property or a dwelling varies from the actual rate determined in accordance with paragraph (a)(1) of this section, in addition to the tolerances applicable under paragraphs (a)(2) and (3) of this section, the disclosed annual percentage rate shall also be considered accurate if:

(i) The rate results from the disclosed finance charge; and

(ii)(A) The disclosed finance charge would be considered accurate under section 226.18(d)(1); or

(B) For purposes of rescission, if the disclosed finance charge would be considered accurate under section 226.23(g) or (h), whichever applies.

(5) *Additional tolerance for mortgage loans.* In a transaction secured by real property or a dwelling, in addition to the tolerances applicable under paragraphs (a)(2) and (3) of this section, if the disclosed finance charge is calculated incorrectly but is considered accurate under section 226.18(d)(1) or section 226.23(g) or (h), the disclosed annual percentage rate shall be considered accurate:

(i) If the disclosed finance charge is understated, and the disclosed annual percentage rate is also understated but it is closer to the actual annual percentage rate than the rate that would be considered accurate under paragraph (a)(4) of this section;

(ii) If the disclosed finance charge is overstated, and the disclosed annual percentage rate is also overstated but it is closer to the actual annual percentage rate than the rate that would be considered accurate under paragraph (a)(4) of this section.

* * * * *

8. Section 226.23 is amended as follows:

a. Paragraphs (b)(1) through (b)(5) are redesignated as paragraphs (b)(1)(i) through (b)(1)(v);

b. Introductory text of paragraph (b) is redesignated as paragraph (b)(1) and republished;

c. A new paragraph (b)(2) is added; and

d. New paragraphs (g) and (h) are added.

The revisions and additions are to read as follows:

Section 226.23—Right of rescission.

* * * * *

(b)(1) *Notice of right to rescind.* In a transaction subject to rescission, a creditor shall deliver two copies of the notice of the right to rescind to each consumer entitled to rescind. The notice shall be on a separate document that identifies the transaction and shall clearly and conspicuously disclose the following:

(i) The retention or acquisition of a security interest in the consumer's principal dwelling.

(ii) The consumer's right to rescind the transaction.

(iii) How to exercise the right to rescind, with a form for that purpose, designating the address of the creditor's place of business.

(iv) The effects of rescission, as described in paragraph (d) of this section.

(v) The date the rescission period expires.

(2) *Proper form of notice.* To satisfy the disclosure requirements of paragraph (b)(1) of this section, the creditor shall provide the appropriate model form in Appendix H of this part or a substantially similar notice.

* * * * *

(g) *Tolerances for accuracy.* (1) *One-half of 1 percent tolerance.* Except as provided in paragraphs (g)(2) and (h)(2) of this section, the finance charge and other disclosures affected by the finance charge (such as the amount financed and the annual percentage rate) shall be considered accurate for purposes of this section if the disclosed finance charge:

(i) Is understated by no more than 1/2 of 1 percent of the face amount of the note or $100, whichever is greater; or

(ii) Is greater than the amount required to be disclosed.

(2) *One percent tolerance.* In a refinancing of a residential mortgage transaction with a new creditor (other than a transaction covered by section 226.32), if there is no new advance and no consolidation of existing loans, the finance charge and other disclosures affected by the finance charge (such as the amount financed and the annual percentage rate) shall be considered accurate for purposes of this section if the disclosed finance charge:

(i) Is understated by no more than 1 percent of the face amount of the note or $100, whichever is greater; or

(ii) Is greater than the amount required to be disclosed.

(h) *Special rules for foreclosures.* (1) *Right to rescind.* After the initiation of foreclosure on the consumer's principal dwelling that secures the credit obligation, the consumer shall have the right to rescind the transaction if:

(i) A mortgage broker fee that should have been included in the finance charge was not included; or

(ii) The creditor did not provide the properly completed appropriate model form in Appendix H of this part, or a substantially similar notice of rescission.

(2) *Tolerance for disclosures.* After the initiation of foreclosure on the consumer's principal dwelling that secures the credit obligation, the finance charge and other disclosures affected by the finance charge (such as the amount financed and the annual percentage rate) shall be considered accurate for purposes of this section if the disclosed finance charge:

(i) Is understated by no more than $35; or

(ii) Is greater than the amount required to be disclosed.

9. Section 226.31 is amended by revising paragraphs (d) and (g) to read as follows:

Section 226.31—General rules.

* * * * *

(d) *Basis of disclosures and use of estimates.* (1) *Legal Obligation.* Disclosures shall reflect the terms of the legal obligation between the parties.

(2) *Estimates.* If any information necessary for an accurate disclosure is unknown to the creditor, the creditor shall make the disclosure based on the best information reasonably available at the time the disclosure is provided, and shall state clearly that the disclosure is an estimate.

(3) *Per-diem interest.* For a transaction in which a portion of the interest is determined on a per-diem basis and collected at consummation, any disclosure affected by the per-diem interest shall be considered accurate if the disclosure is based on the information known to the creditor at the time that the disclosure documents are prepared.

* * * * *

(g) *Accuracy of annual percentage rate.* For purposes of section 226.32, the annual percentage rate shall be considered accurate, and may be used in determining whether a transaction is covered by section 226.32, if it is accurate according to the requirements and within the tolerances under section 226.22. The finance charge tolerances for rescission under section 226.23(g) or (h) shall not apply for this purpose.

10. In Part 226, Appendix H is amended by revising the H-9 Rescission Model Form and the contents listing at the beginning of Appendix H to read as follows:

Appendix H to Part 226—Closed End Model Forms and Clauses

H-1—Credit Sale Model Form (section 226.18)
H-2—Loan Model Form (section 226.18)
H-3—Amount Financed Itemization Model Form (section 226.18(c))
H-4(A)—Variable-Rate Model Clauses (section 226.18(f)(1))
H-4(B)—Variable-Rate Model Clauses (section 226.18(f)(2))
H-4(C)—Variable-Rate Model Clauses (section 226.19(b))
H-4(D)—Variable-Rate Model Clauses (section 226.20(c))
H-5—Demand Feature Model Clauses (section 226.18(I))
H-6—Assumption Policy Model Clause (section 226.18(q))
H-7—Required Deposit Model Clause (section 226.18(r))
H-8—Rescission Model Form (General) (section 226.23)
H-9—Rescission Model Form (Refinancing With Original Creditor) (section 226.23)
H-10—Credit Sale Sample
H-11—Installment Loan Sample
H-12—Refinancing Sample
H-13—Mortgage with Demand Feature Sample
H-14—Variable-Rate Mortgage Sample (section 226.19(b))
H-15—Graduated Payment Mortgage Sample
H-16—Mortgage Sample (section 226.32)

* * * * *

H-9—Rescission Model Form (Refinancing with Original Creditor)

NOTICE OF RIGHT TO CANCEL

Your Right to Cancel

You are entering into a new transaction to increase the amount of credit previously provided to you. Your home is the security for this new transaction. You have a legal right under federal law to cancel this new transaction, without cost, within three business days from whichever of the following events occurs last:

(1) The date of this new transaction, which is ________________; or

(2) The date you received your new Truth in Lending disclosures; or

(3) The date you received this notice of your right to cancel.

If you cancel this new transaction, it will not affect any amount that you presently owe. Your home is the security for that amount. Within 20 calendar days after we receive your notice of cancellation of this new transaction, we must take the steps necessary to reflect the fact that your home does not secure the increase of credit. We must also return any money you have given to us or anyone else in connection with this new transaction.

You may keep any money we have given you in this new transaction until we have done the things mentioned above, but you must then offer to return the money at the address below. If we do not take possession of the money within 20 calendar days of your offer, you may keep it without further obligation.

How to Cancel

If you decide to cancel this new transaction, you may do so by notifying us in writing, at

(creditor's name and business address).

You may use any written statement that is signed and dated by you and states your intention to cancel, or you may use this notice by dating and signing below. Keep one copy of this notice because it contains important information about your rights.

If you cancel by mail or telegram, you must send the notice no later than midnight of _________(date)_________ (or midnight of the third business day following the latest of the three events listed above).

If you send or deliver your written notice to cancel some other way, it must be delivered to the above address no later than that time.

I WISH TO CANCEL

____________________________ ______________
Consumer's Signature Date

11. In Supplement I to Part 226, under *Section 226.4—Finance Charge,* under *4(a) Definition,* paragraph 3. ii. is removed.
12. In Supplement I to Part 226, under *Section 226.17—General Disclosure Requirements*, under *17(c) Basis of disclosures and use of estimates,* paragraph 17(c)(2) is redesignated as paragraph 17(c)(2)(i):

Supplement I Official Staff Interpretation

* * * * *

Section 226.17—General Disclosure Requirements

* * * * *

17(c) Basis of Disclosures and Use of Estimates

* * * * *

Paragraph 17(c)(2)(i).

* * * * *

13. In Supplement I to Part 226, under *Section 226.18—Content of Disclosures*, under *18(d) Finance charge,* paragraph 2 is removed.
14. In Supplement I to Part 226, under *Section 226.23—Right of Rescission,* under *23(b) Notice of right to rescind,* the first sentence of paragraph 3 is revised to read as follows:

Section 226.23—Right of Rescission.

* * * * *

23(b) Notice of right to rescind

* * * * *

3. *Content.* The notice must include all of the information outlined in Section 226.23(b)(1)(i) through (v). * * *

* * * * *

ORDERS ISSUED UNDER BANK HOLDING COMPANY ACT

Orders Issued Under Section 3 of the Bank Holding Company Act

Valley View Bancshares, Inc.
Overland Park, Kansas

Order Approving Application to Acquire Bank Holding Companies

Valley View Bancshares, Inc., Overland Park, Kansas ("Valley View"), a bank holding company within the meaning of the Bank Holding Company Act ("BHC Act"), has requested the Board's approval under section 3 of the BHC Act (12 U.S.C. § 1842) to acquire Industrial Bancshares, Inc., and its subsidiary bank, Industrial State Bank ("Industrial Bank"), both of Kansas City, Kansas; International Bancshares, Inc., and its subsidiary bank, First Bank of Missouri ("First Bank"), both of Gladstone, Missouri; Mission Bancshares, Inc., and its subsidiary bank, The Mission Bank, both of Mission, Kansas; and One Security, Inc., and its subsidiary bank, Security Bank ("Security Bank"), both of Kansas City, Kansas.[1]

Notice of the proposal, affording interested persons an opportunity to submit comments, has been published (61 *Federal Register* 31,526 (1996)). The time for filing comments has expired, and the Board has considered the proposal and all comments received in light of the factors set forth in section 3 of the BHC Act.

The Affiliated Companies, with total consolidated assets of approximately $1.6 billion, operate four subsidiary

1. The bank holding companies involved in the proposal comprise the Morgan chain banking organization ("Affiliated Companies"), and the proposal represents a reorganization of the Affiliated Companies into a single bank holding company. On consummation of the proposal, Valley View would directly own all of the voting shares of the subsidiary banks currently owned by the Affiliated Companies.

banks in Kansas and one subsidiary bank in Missouri.[2] The Affiliated Companies are the fourth largest commercial banking organization in Kansas, controlling approximately $1.1 billion in deposits, representing 3.2 percent of total deposits in commercial banking organizations in the state.[3] The subsidiary bank of the Affiliated Companies in Missouri is the 51st largest commercial banking organization in the state, controlling approximately $238 million in deposits, representing less than 1 percent of total deposits in commercial banking organizations in the state.

Interstate Analysis

Section 3(d) of the BHC Act, as amended by the section 101 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, allows the Board to approve an application by a bank holding company to acquire control of a bank located in a state other than the home state of such bank holding company, if certain conditions are met. For purposes of the BHC Act, the home state of Valley View is Kansas, and Valley View would acquire a bank in Missouri.[4] The conditions for an interstate acquisition under section 3(d) are met in this case.[5] In view of all the facts of record, the Board is permitted to approve the proposal under section 3(d) of the BHC Act.

Competitive Considerations

Section 3 of the BHC Act prohibits the Board from approving an application if the proposal would result in a monopoly, or would substantially lessen competition in any relevant market unless such anticompetitive effects are clearly outweighed in the public interest by the probable effects of the transaction in meeting the convenience and needs of the community to be served. As noted above, the proposal represents a reorganization of the Affiliated Companies to form a single bank holding company. Based on all the facts of record, the Board concludes that consummation of the proposal would not have any significantly adverse effects on competition or the concentration of banking resources in any relevant banking market. Accordingly, the Board concludes that competitive considerations are consistent with approval.

Other Factors under the BHC Act

The BHC Act also requires the Board to consider the financial and managerial resources and future prospects of the companies and banks involved, as well as considerations relating to the convenience and needs of the community to be served and other supervisory factors. The Board has carefully reviewed the financial and managerial resources and future prospects of Valley View and the bank holding companies to be acquired in light of all the facts of record, including relevant supervisory reports of examination. The Board notes that Valley View is in satisfactory financial condition and would remain so after consummation of the proposal. In addition, reports of examination assessing the managerial resources of Valley View and the other bank holding companies indicate this factor is consistent with approval. Based on all the facts of record, the Board concludes that considerations related to the financial and managerial resources and future prospects of Valley View and the bank holding companies to be acquired are consistent with approval, as are other supervisory factors the Board must consider.

Convenience and Needs Factor

The Board has long held that consideration of the convenience and needs factor includes a review of the records of the relevant depository institutions under the Community Reinvestment Act (12 U.S.C. § 2901 *et seq.*) (''CRA''). As provided in the CRA, the Board has evaluated this factor in light of examinations by the primary federal supervisory of the CRA performance record of the relevant institutions.

An institution's most recent CRA performance evaluation is a particularly important consideration in the applications process because it represents a detailed on-site evaluation of an institution's overall record of performance under the CRA by its primary federal supervisor.[6] In addition, the Board considers an institution's policies and practices for compliance with applicable fair lending laws. The Board also has taken into account information on an institution's lending activities that assist in meeting the credit needs of low- and moderate-income neighborhoods.

The Board also has carefully considered comments from The Concerned Clergy Coalition (''Protestant''), which generally allege that the Affiliated Companies have failed to include the inner cities of Kansas City, Kansas, and Kansas City, Missouri, within their delineated community or to assist in meeting the credit needs of these areas. In particular, Protestant alleges that Security Bank has focused its lending efforts outside its delineated community, engaged in insufficient residential and small business lend-

2. Asset data are as of June 30, 1996.

3. State deposit data are as of June 30, 1995.

4. Pub. L. No. 103–328, 108 Stat. 2338 (1994). A bank holding company's home state is the state in which the operations of the bank holding company's banking subsidiaries were principally conducted on July 1, 1966, or the date on which the company became a bank holding company, whichever is later.

5. *See* 12 U.S.C. § 1842(d)(1)(A) and (B) and 1842(d)(2)(A) and (B). Valley View is adequately capitalized and adequately managed. Gladstone Bank has been in existence and continuously operated for the minimum period of time required under Missouri law. In addition, on consummation of the proposal, Valley View and its affiliates would control less than 10 percent of the total amount of deposits of insured depository institutions in the United States, and less than 13 percent of the total amount of deposits of insured depository institutions in Missouri, as required by state law.

6. The Statement of the Federal Financial Supervisory Agencies Regarding the Community Reinvestment Act provides that a CRA examination is an important and often controlling factor in consideration of an institution's CRA record and that reports of these examinations will be given great weight in the applications process. *See* 54 *Federal Register* 13,742, 13,745 (1989).

ing activities, engaged in ineffective ascertainment and marketing efforts, and provided inadequate branch facilities.[7] Protestant also alleges that Security Bank and Industrial Bank have failed to participate adequately in community development programs serving their delineated community.[8]

Performance Examinations. All the subsidiary banks of the Affiliated Companies have received ''satisfactory'' ratings from their primary federal supervisors in their most recent evaluations for CRA performance.[9] In particular, Security Bank received a ''satisfactory'' rating from the Federal Deposit Insurance Corporation (''FDIC'') at its most recent examination as of April 1996 (''Security Examination''),[10] and Industrial Bank received a ''satisfactory'' rating for CRA performance from the FDIC as of September 1994 (''Industrial Examination'').

Performance Record of Security Bank. The Security Examination noted that the bank focuses on commercial real estate and other commercial and industrial lending, including a substantial number of loan participations throughout its region. Consistent with Security Bank's business strategy, the bank primarily assists in meeting the credit needs of its community through direct loans to businesses and participation in the financing of larger housing rehabilitation projects. For example, during 1994, 1995, and the first part of 1996, the bank made 153 commercial and real estate loans in the aggregate amount of $18.9 million in its delineated community.[11] Examiners found the overall geographic distribution of the bank's credit extensions to be reasonable.

Security Bank also significantly increased its community development lending during the same period. In 1994, the bank funded five projects in the aggregate amount of $706,000, including $400,000 to rehabilitate a 28-unit low-income apartment complex. An additional $1.5 million was committed to fund a low-income single family dwelling development project. In 1995, the bank funded four projects in the aggregate amount of $2.7 million, including $2 million to help rehabilitate 217 low- and moderate-income apartment units in a 12-building complex, and $550,000 to help develop 200 low- and moderate-income housing units at the Quality Hill Apartments. During the first part of 1996, Security Bank states that it loaned $4.9 million to nine redevelopment projects, including $3.1 million in bond financing to support the renovation of the Twin Oaks apartments to create 600 low- and moderate-income housing units.

Protestant criticizes the small number of housing-related loans reflected in the bank's data submitted under the Home Mortgage Disclosure Act (''HMDA''). As previously noted, Security Bank is primarily a commercial lender and the HMDA data is consistent with its business orientation. The Board also recognizes that HMDA data alone provide an incomplete measure of an institution's lending in its community because these data cover only a few categories of housing-related lending and provide limited information about the covered loans. The bank's HMDA data, nevertheless, reflect positive efforts by Security Bank to assist in meeting the credit needs of all members of its community. Between January 1994 and March 1996, loans were originated for 67 percent of the applications received from minority applicants and 64 percent of the applications received from residents of low- and moderate-income census tracts.[12] During 1993 through 1995, the percentage of home mortgage applications that Security Bank received from African-American applicants, Hispanic applicants, and residents of low- and moderate-income census tracts generally exceeded that of lenders in the market in the aggregate. The Security Examination found no evidence of prohibited discriminatory practices or any other practices designed to discourage loan applications.

Examiners also noted that three of Security Bank's five offices were located in low- and moderate-income census tracts and that their services and business hours appeared to be sufficient to meet the needs of the local community. In 1995, Security Bank conducted a survey by mail of more than 2,400 deposit customers at all its facilities, and

7. Protestant requests that the Board condition its approval of the proposal by requiring Valley View to implement several specific steps that Protestant contends would improve the CRA performance of all the banks involved in the proposal. These steps include: extending the home mortgage purchase products of Valley View's subsidiary bank, Valley View State Bank, Overland Park, Kansas (''Valley View Bank''), to Security Bank and Industrial Bank; expanding home mortgage, consumer, community development, and small business lending by Security Bank and Industrial Bank in their delineated community; establishing an additional full-service branch of Security Bank in its delineated community; and extending the delineated communities of certain banks to include the inner city of Kansas City, Missouri.

8. Protestant criticizes Security Bank for its lack of involvement with several government-sponsored and private community development programs that Protestant describes as being active in Security Bank's delineated community and supported by several other financial institutions. The Board notes that the CRA provides banks with substantial leeway in developing specific CRA-related policies and programs and does not require participation in any particular type of activity or program.

9. Protestant contends that Valley View Bank and First Bank, which serve suburban and other outlying areas of the Kansas City banking market, should extend their delineated communities under the CRA to include the inner city of Kansas City, Missouri, and establish branches there. The most recent CRA examinations of all banks owned by the Affiliated Companies, including Valley View Bank and First Bank, found that the delineated community for each bank was reasonable and did not arbitrarily exclude low- and moderate-income areas.

10. Protestant criticizes the Security Examination and contends that the CRA performance of Security Bank is substantially unchanged since it received a ''needs to improve'' rating at its examination in September 1992. The FDIC has conducted two evaluations of Security's CRA performance since the 1992 examination, and both examinations (October 1993 and the Security Examination in 1996) have rated the bank's performance as ''satisfactory.''

11. Protestant notes that the bank made only one or two Small Business Administration (''SBA'') loans annually. Valley View states that Security Bank recently hired a loan officer with SBA lending experience and that the bank is developing a plan to become more active in SBA lending.

12. During this period, Security Bank originated loans for 68 percent of the applications it received in the aggregate.

received 900 responses. Surveyed customers were asked about the bank's lobby hours, locations, employee courtesy and personal service, and community involvement. More than 90 percent of respondents rated the bank excellent or adequate overall. The Security Examination also found that the bank maintained an adequate branch closing policy.

The Security Examination found that Security Bank undertook reasonable efforts to ascertain the credit needs of its entire community, especially through involvement in several civic organizations and an officer call program. Examiners noted that marketing efforts included weekly advertisements in several newspapers serving the local community, including a bilingual newspaper serving Hispanic members of the community, and that the bank has hired a bilingual employee at its main office to assist Hispanic customers. Examiners also noted that the board of directors of the bank was adequately involved in the formulation and monitoring of CRA programs and ensured the proper training of officers and employees.

Performance Record of Industrial Bank. Industrial Bank also is primarily a commercial lender. Examiners reviewed the geographic distribution of the bank's commercial, housing-related and consumer loans, credit applications, and credit denial, and found that the distribution was reasonable. For example, examiners found that 41 percent of all commercial loans and 70 percent of all consumer loans that the bank had extended since the prior CRA examination were made within the bank's delineated community. Ninety-three percent of all home mortgage applications and 90 percent of the home mortgage loans originated also were in the delineated community. Examiners also found the bank's involvement with community development projects within its community to be adequate. In 1995 and the first part of 1996, the bank funded nine projects in the aggregate amount of $1.2 million, including $550,000 to help rehabilitate the Quality Hill apartment complex and $448,000 for the development of a church-supported community center. The bank also loaned $84,000 and committed an additional $40,000 to individuals for the rehabilitation of low-income housing units.

The Industrial Examination found no substantive violations of the fair lending laws or any other practices designed to discourage loan applications.[13] Examiners found that the bank relied on direct contacts with government officials and community organizations, as well as calls on customers, to ascertain credit needs. Through its ascertainment efforts, the bank financed a merger of the area's largest minority-owned construction company and the purchase of equipment by another minority-owned firm. The bank also determined through its ascertainment efforts that a need existed in its community for additional home improvement loans, and developed fixed-rate term loan and home equity loan products to address this need. Industrial Bank also has hired six bilingual employees to assist Hispanic customers.

Conclusion on Convenience and Needs Factor

The Board has carefully considered the entire record in its review of the convenience and needs factor under the BHC Act. Based on all the facts of record, including information provided by Protestant and Valley View and CRA performance examinations, the Board concludes that the efforts of Valley View and the subsidiary banks of the Affiliated Companies to help meet the credit needs of all segments of the communities served, including low- and moderate-income neighborhoods and minority residents, and the convenience and needs considerations, are consistent with approval, and thus there is no need to require the conditions suggested by Protestant.

Based on all the facts of record, the Board has determined that this application should be, and hereby is, approved.[14] The Board's approval is specifically conditioned on compliance by Valley View with all the commitments made in connection with this application. For the purpose of this action, the commitments and conditions relied on by the Board in reaching its decision are deemed to be conditions imposed in writing by the Board in connection with its findings and decision and, as such, may be enforced in proceedings under applicable law.

The proposed acquisition of the other bank holding companies in the Morgan Group shall not be consummated before the fifteenth calendar day following the effective date of this order, and not later than three months after the effective date of this order, unless such period is extended for good cause by the Board or by the Federal Reserve Bank of Kansas City, acting pursuant to delegated authority.

By order of the Board of Governors, effective September 16, 1996.

13. Examiners noted certain technical violations of fair lending laws, which they did not consider to reflect negatively on Industrial Bank's lending practices.

14. Protestant has requested that the Board hold a public hearing or meeting to receive public testimony on the proposal. Section 3(b) of the BHC Act does not require the Board to hold a public hearing or meeting on an application unless the appropriate supervisory authority for the bank to be acquired makes a timely written recommendation of denial of the application. In this case, the Board has received no such request. Under its rules, the Board may, in its discretion, hold a public hearing or meeting on an application to clarify factual issues related to the application and to provide an opportunity for testimony, if appropriate. 12 C.F.R. 262.3(e) and 262.25(d). The Board has carefully considered Protestant's request in light of all the facts of record. In the Board's view, Protestant has had ample opportunity to submit its views and has, in fact, submitted substantial written materials that have been considered by the Board in acting on the application. Protestant fails to demonstrate why its substantial written submissions do not adequately present its allegations or why a public hearing or meeting is otherwise warranted in this case. For these reasons, and based on all the facts of record, the Board has determined that a public hearing or meeting is not necessary to clarify the factual record in the application, and is not warranted in this case. Accordingly, Protestant's request for a public hearing or meeting is denied.

Voting for this action: Chairman Greenspan, Vice Chair Rivlin, and Governors Kelley, Lindsey, Phillips, Yellen, and Meyer.

JENNIFER J. JOHNSON
Deputy Secretary of the Board

Orders Issued Under Section 4 of the Bank Holding Company Act

Cambridge Bancorp
Cambridge, Massachusetts

Order Approving a Notice to Engage in Certain Investment Advisory Activities

Cambridge Bancorp, Cambridge, Massachusetts (''Cambridge''), a bank holding company within the meaning of the Bank Holding Company Act (''BHC Act''), has requested the Board's approval under section 4(c)(8) of the BHC Act (12 U.S.C. § 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) to expand the investment advisory activities of its subsidiary, Cambridge Investment Services of New Hampshire, Inc., Concord, New Hampshire (''Company''), to provide discretionary investment management services to customers who do not qualify as institutional customers under Regulation Y.[1]

Notice of the proposal, affording interested persons an opportunity to submit comments, has been published (61 *Federal Register* 41,415 (1996)). The time for filing comments has expired, and the Board has considered the notice and all comments received in light of the factors set forth in section 4(c)(8) of the BHC Act.

Cambridge, with total consolidated assets of $404.9 million, controls one commercial bank, Cambridge Trust Company, Cambridge, Massachusetts (''CTC'').[2] Cambridge recently established Company to engage in investment advisory activities.[3] Company has not yet commenced operations, and it currently has an application pending with the Securities and Exchange Commission for registration as an investment adviser under the Investment Advisers Act of 1940 (15 U.S.C. § 80b-1 *et seq.*) (''Investment Advisers Act''). Cambridge has committed that Company will register under the Investment Advisers Act before providing the proposed service.

Section 4(c)(8) of the BHC Act provides that a bank holding company may engage, with Board approval, in any activity that the Board determines to be ''so closely related to banking or managing or controlling banks as to be a proper incident thereto.''[4] The Board previously has determined that providing discretionary investment management services to retail customers is closely related to banking.[5]

In order to approve this notice, the Board must also consider whether the performance of the proposed activity by Cambridge is a proper incident to banking, that is whether the activity proposed ''can reasonably be expected to produce benefits to the public . . . that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices.''[6] As part of its evaluation of these factors, the Board considers the financial condition and managerial resources of the notificant and its subsidiaries and the effect of the proposed transaction on these resources.[7] Based on all the facts of record, including relevant reports of examination, the Board has concluded that financial and managerial considerations are consistent with approval of the proposal. The Board also expects that consummation of the proposal would result in greater competition in the market for retail-level discretionary management services and provide added convenience and services to retail customers.

In the *CNB Order,* the Board relied on certain conditions and limitations to mitigate potential adverse effects, such as conflicts of interests and customer confusion, that might arise from the provision of discretionary management services to retail customers. Cambridge has committed that Company will conduct the proposed activity under substantially the same limitations and conditions as those in the *CNB Order,* as listed in Appendix A.

Cambridge also has requested that it be permitted to advertise and market the availability of the services of Company through CTC's branches, including by making referrals and providing brochures and other literature, and to disclose the affiliation of Company with CTC. To mitigate the potential for customer confusion about the uninsured nature of the investments made through Company that might result from such promotional activities, Cambridge has stated that all brochures and advertisements of Company will contain the disclosures required in the Interagency Statement on the Retail Sale of Nondeposit Investment Products (''Interagency Statement''). Cambridge has further committed that each client, before he or she enters into an advisory relationship with Company, will receive a written disclosure that complies with the disclosure requirements of the Interagency Statement. Thus, Cambridge would disclose that Company is a separate entity from CTC; that securities purchased through Company are not guaranteed by Company or CTC; that accounts of Company are not insured by the Federal Deposit Insurance Corporation (''FDIC''); and that assets invested with Company are subject to the risk of loss, including possible loss of the principal invested.

1. 12 C.F.R. 225.2(g).
2. Asset data are as of June 30, 1996.
3. Cambridge previously received approval for Company to provide investment advice to institutional customers. *See* 12 C.F.R. 225.25(b)(4)(iii).
4. 12 U.S.C. § 1843(c)(8).
5. *See CNB Financial Corp.,* 82 *Federal Reserve Bulletin* 952 (1996) (''*CNB Order*''); *CoreStates Financial Corp.,* 80 *Federal Reserve Bulletin* 644 (1994).
6. 12 U.S.C. § 1843(c)(8).
7. *See* 12 C.F.R. 225.24.

Based on all the facts of record, the Board finds that the public benefits of Cambridge's proposed activity outweigh any likely adverse effects and, therefore, that the activity is a proper incident to banking for purposes of section 4(c)(8) of the BHC Act.

Based on the foregoing and all the facts of record, the Board has determined that the notice should be, and hereby is, approved. Approval of this notice is specifically conditioned on compliance by Cambridge with the commitments discussed in this order and all other commitments and representations made by Cambridge in connection with this notice. The Board's determination also is subject to all the terms and conditions set forth in Regulation Y, including those in sections 225.7 and 225.23(b) (12 C.F.R. 225.27 and 225.23(b)), and to the Board's authority to require such modification or termination of the activities of a bank holding company or any of its subsidiaries as the Board finds necessary to ensure compliance with, and to prevent evasion of, the provisions of the BHC Act and the Board's regulations and orders thereunder. For purposes of this transaction, the commitments and conditions agreed to by Cambridge shall be deemed to be conditions imposed in writing by the Board in connection with its findings and decision and, as such, may be enforced in proceedings under applicable law.

These activities shall not be commenced later than three months after the effective date of this order, unless such period is extended for good cause by the Board or by the Federal Reserve Bank of Boston pursuant to delegated authority.

By order of the Board of Governors, effective September 30, 1996.

Voting for this action: Chairman Greenspan, Vice Chair Rivlin, and Governors Kelley, Lindsey, Phillips, Yellen, and Meyer.

JENNIFER J. JOHNSON
Deputy Secretary of the Board

Appendix A

Cambridge has committed that it would comply with the following conditions:

(1) No investment transactions will be executed by Company on behalf of retail customers through any broker affiliated with Cambridge;

(2) Company will not purchase, for discretionary investment advisory accounts, securities for which Cambridge or any of its affiliates acts as underwriter, dealer, distributor, or placement agent, other than obligations of the United States, unless directed to do so in writing by the client prior to each such transaction and after disclosure of any such affiliated relationships involved in the transaction;

(3) Fees charged by Company to its retail customers for its discretionary investment advisory services will not be based on the number of transactions executed;

(4) Company, Cambridge, and affiliates of Cambridge will not share confidential information regarding their respective customers without the customer's consent;

(5) Company's offices will not be located in, located in the same building as, or geographically proximate, to any branches of CTC; and

(6) Referrals of retail customers to Company by CTC will be made only by CTC trust department or senior management personnel. No such referrals will be made without first providing the customer with written or oral disclosures of the distinct and separate identities of CTC and Company. Before entering into an advisory relationship with Company, each retail customer will receive a written disclosure that Company is a separate entity from CTC; that securities purchased through Company are not insured by the FDIC or guaranteed by Company or CTC; and that assets invested with Company are subject to the risk of loss, including possible loss of the principal invested. In addition, Cambridge, Company, and CTC will otherwise comply with the Interagency Statement on Retail Sales of Nondeposit Investment Products and its interpretations.

The Chase Manhattan Corporation
New York, New York

Mellon Bank Corporation
Pittsburgh, Pennsylvania

Order Approving Notice to Acquire Certain Trust-Related Assets

The Chase Manhattan Corporation, New York, New York (''Chase''), and Mellon Bank Corporation, Pittsburgh, Pennsylvania (''Mellon''), bank holding companies within the meaning of the Bank Holding Company Act (''BHC Act''), have requested the Board's approval under section 4 of the BHC Act (12 U.S.C. § 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) to acquire indirectly assets related to the shareholder service operations of Wells Fargo Bank, N.A., San Francisco, California, and its affiliated banks (collectively ''Wells''), and thereby engage in trust-related services pursuant to section 225.25(b)(3) of the Board's Regulation Y (12 C.F.R. 225.25(b)(3). Chase and Mellon propose to acquire the Wells Fargo shareholder services assets through their joint venture subsidiary, ChaseMellon Shareholder Services, L.L.C., Ridgefield Park, New Jersey (''Chase/Mellon'').[1]

Notice of this proposal, affording interested persons an opportunity to submit comments, has been published (61 *Federal Register* 42,615, 43,060 (1996)). The time for filing comments has expired, and the Board has considered the notice and all comments received in light of the factors set forth in section 4(c)(8) of the BHC Act.

1. Chase and Mellon each own 50 percent of Chase/Mellon through wholly owned subsidiaries.

Chase, the largest commercial banking organization in the United States with total consolidated assets of approximately $321.8 billion, operates banks in Delaware, Florida, New Jersey, New York, and Texas, and engages in a number of permissible activities nationwide.[2] Mellon, with total consolidated assets of $42.8 billion, is the 22d largest commercial banking organization in the United States. Mellon operates banking subsidiaries in Pennsylvania, Delaware, Maryland, and New Jersey, and engages in a number of nonbanking activities nationwide.

Proposed Trust-Related Activities

The Board previously has determined that the provision of certain shareholder services, including acting as a stock transfer and dividend disbursing agent and providing similar custodial or agency services, may be performed by bank holding companies pursuant to section 225.23(b)(3) of Regulation Y.[3] Chase/Mellon provides a full range of permissible shareholder services pursuant to Regulation Y, and all of the Wells assets to be acquired in the proposal relate to activities that are permissible for bank holding companies.[4]

In considering this proposal, the Board also must determine whether the proposed activities are a proper incident to banking, that is, whether the proposal ''can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices.''[5] As part of its evaluation of these factors, the Board has carefully reviewed the financial and managerial resources of Chase and Mellon and their respective subsidiaries, and the effect the transaction would have on such resources in light of all the facts of record.[6] This includes review of confidential reports of examination prepared by the primary federal supervisors of the organizations assessing the financial and managerial resources of these organizations. Based on all the facts of record, the Board concludes that the financial and managerial resources of the organizations involved in the proposal are consistent with approval.[7]

In evaluating the competitive effects of the proposal, the Board notes that Wells does not control a significant share of the market for shareholder services and that the effect of the acquisition in the market for these services would be small. In addition, the market for shareholder services is not highly concentrated and customers for these services are sophisticated financial institutions with substantial bargaining power. Based on all the facts of record, the Board concludes that consummation of the proposal would not have a significantly adverse effect on competition in any relevant market.[8]

In reviewing the public interest factors in this case, the Board also has carefully considered contentions by Protestant that the public benefits are not sufficient to outweigh

2. Asset data are as of June 30, 1996.

3. *See State Street Boston Corporation,* 81 *Federal Reserve Bulletin* 1049 (1995).

4. The shareholder services activities of Wells are set forth in the Appendix.

5. 12 U.S.C. § 1843(c)(8). *See* 12 C.F.R. 225.24; *see also The Fuji Bank, Limited*, 75 *Federal Reserve Bulletin* 94 (1989); *Bayerische Vereinsbank AG,* 73 *Federal Reserve Bulletin* 155 (1987).

6. Inner City Press/Community on the Move, Bronx, New York (''Protestant''), contends that the Board's order regarding the merger of The Chase Manhattan Corporation and Chemical Banking Corporation, both of New York, New York, *Chemical Banking Corporation*, 82 *Federal Reserve Bulletin* 239 (1996) (''Chemical/Chase Order''), misanalyzed and misinterpreted a number of issues raised by the merger of Chemical and Chase, including the potential anticompetitive effects of the merger, the impact of the announced branch closings on low- and moderate-income (''LMI'') communities and communities with predominately minority populations, and the reliability of the data submitted under the Home Mortgage Disclosure Act (''HMDA'') relating to loans made through the New York City Partnership. In addition, Protestant argues that the availability of new information since the Chemical/Chase Order, including Chase's HMDA data for 1995 and criticisms by the General Accounting Office of examiner fair lending training and enforcement policies of the federal financial supervisory agencies, require the Board to reconsider the conclusions reached in the Chemical/Chase Order on these issues. As explained in the Chemical/Chase Order, the Board concluded, on the basis of all the facts of record, that the proposal met the competitive, convenience and needs, and other statutory factors the Board is required to consider and should be approved. Protestant's request that the Board reconsider its decision in the Chemical/Chase merger has already been denied.

7. Protestant alleges that the 1995 HMDA data for Chase indicate some disparities in the rate of denials and originations for housing-related loans by racial groups, that Chase has made several misleading and inaccurate media announcements regarding branch closings, that Chase has abandoned LMI areas through branch closings since the merger, and that Chase has not opened certain branches and automated teller machines (''ATMs'') in LMI areas identified in connection with the Board's approval of the Chemical/Chase Order. Protestant also maintains that other aspects of Chase's operations reflect adversely on managerial considerations, including trading in unregistered copper futures by Chase Bank, problems with ATM services and billing errors in Chase's secured credit card program, and the departure of mid- and high-level management from Chase. The Board has reviewed all of these allegations in light of supervisory assessments of Chase's managerial resources and Chase's adherence to fair lending and other laws, and updated information from Chase on its branch openings and closings and ATM installations in LMI census tracts, including the facilities discussed by Protestant. The Board notes that the merger of Chemical and Chase, which involved two of the largest domestic banking organizations, was not consummated until July 14, 1996, and that Chase has already begun to implement the programs and policies discussed in the Chemical/Chase Order. The Board also notes that Chase has demonstrated that it has the managerial resources to conduct the activities proposed in this case.

8. Protestant maintains that the Board should consider the competitive effect of all business relationships between Mellon and Chase and reconsider the approval of the Chase/Mellon joint venture. In connection with the formation of Chase/Mellon, both banking organizations made a number of commitments to address conflicts of interests and other adverse effects that could result from a matrix of relationships between co-venturers. In particular, Chase and Mellon committed not to solicit business on behalf of each other and represented that they did not have or expect to have significant business relationships outside the joint venture. Chase and Mellon also committed to act on an arm's-length basis in deciding whether to extend credit to any co-venturer or co-venturer's competitor and not to take into account the fact that a potential borrower could be a competitor of Chase/Mellon in deciding whether to extend credit.

the adverse effects of this proposal. The record indicates that the proposal would provide added convenience to the customers of Wells by continuing to provide them with shareholder services from a company committed to these activities. Moreover, the Board believes that there are public benefits derived from permitting capital markets to operate so that bank holding companies may make potentially profitable investments in nonbanking companies and allocate their resources in the manner they believe is most efficient when these investments are consistent with the relevant considerations under the BHC Act, as they are in this case.

For the reasons discussed in this order, the Board believes that the potential for adverse effects, if any, resulting from the transaction are negligible. The Board also concludes that, based on the considerations discussed above, the proposal can reasonably be expected to produce notable public benefits. Accordingly, based on all the facts of record, the Board has determined that consummation of the proposal can reasonably be expected to produce public benefits that would outweigh any likely adverse effects under the proper incident to banking standard of section 4(c)(8) of the BHC Act.

Conclusion

Based on the foregoing and all the facts of record, the Board has determined that the notice should be, and hereby is, approved. The Board's determination is subject to all the terms and conditions set forth in the Board's Regulation Y, including those in sections 225.7 and 225.23(g) (12 C.F.R. 225.7 and 225.23(g)), and to the Board's authority to require such modification or termination of the activities of a bank holding company or any of its subsidiaries as the Board finds necessary to assure compliance with, and to prevent evasion of, the provisions of the BHC Act and the Board's regulations and orders issued thereunder. The Board's approval is specifically conditioned on compliance with all the commitments made in connection with this proposal, including the commitments discussed in this order. These commitments and conditions shall be deemed to be conditions imposed in writing by the Board in connection with its findings and decision and, as such, may be enforced in proceedings under applicable law.

This transaction shall not be consummated later than three months following the effective date of this order, unless such period is extended for good cause by the Board or both the Federal Reserve Bank of New York and the Federal Reserve Bank of Cleveland acting pursuant to delegated authority.

By order of the Board of Governors, effective September 30, 1996.

Voting for this action: Chairman Greenspan, Vice Chair Rivlin, and Governors Kelley, Lindsey, Phillips, Yellen, and Meyer.

JENNIFER J. JOHNSON
Deputy Secretary of the Board

Appendix

Shareholder Services Activities of Wells

(1) Maintaining the shareholder records, including name, address, and number of shares owned, for its corporate customers and ensuring that the corporation's shareholder list remains current.
(2) Preparing and mailing checks to dividend holders.
(3) Mailing quarterly and annual reports, ''welcome letters'' on behalf of the corporation to its new shareholders, and proxy materials for annual or special meetings.
(4) Mailing annual meeting materials to shareholders, tabulating votes for the various propositions on proxy statements, and serving as the Inspector of Election for annual meetings (which may involve presenting the shareholder vote counts to the corporation's board of directors and shareholders at the annual meeting).
(5) Canceling shares in the name of the transferor name and issuing shares in the name of the acquirer pursuant to the sell or transfer of shares.
(6) Providing shareholders information regarding end-of-year tax reports, lost dividend checks, dividend rates, dates of prior transfers of stock, procedures for transferring shares.
(7) Facilitating the transfer of shares during the course of corporate reorganizations by providing lists of the shareholders of the stock to be acquired, informing the shareholders (by mail) of the transaction and supplying them with the instructions and forms to be used in tendering their shares, processing the tendered shares and issuing the merger or acquisition compensation to the appropriate shareholders.
(8) Maintaining the shareholder records, including name, address, and number of shares owned, for the employee stock option plans of its corporate customers.
(9) Examining shares and any corresponding legal documents submitted in conjunction with the transfer of shares containing legends on the back of the certificates that denote certain restrictions on the sale or transfer of the shares.
(10) Following the purchase activity of certain shares and issuing reports detailing the names of purchasers, brokers used to purchase shares, and number of shares purchased, to its corporate customers;
(11) Contacting shareholders on behalf of corporations, to remind the shareholders to submit their vote or proxy for annual shareholder meetings or special shareholder meetings;
(12) Providing escheat services for abandoned property (*i.e.*, unclaimed dividends and shares of stock).
(13) Providing corporate customers with on-line inquiry access into Chase/Mellon's databases containing information on the corporation's shareholders.
(14) Performing various statistical analyses and generating various reports concerning the corporation's shareholder base.

(15) Maintaining separate databases of shares purchased through the dividend reinvestment plans (''DRP'') or employee stock purchase plans (''ESPP'') for its corporate customers.

National Westminster Bank Plc
London, England

Order Approving Notice to Engage in Certain Nonbanking Activities

National Westminster Bank Plc, London, England (''NatWest''), a foreign banking organization subject to the Bank Holding Company Act (''BHC Act''), has requested the Board's approval under section 4(c)(8) of the BHC Act (12 U.S.C. § 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) to acquire Greenwich Capital Holdings, Inc., Greenwich, Connecticut (''Company''), and thereby engage in the following nonbanking activities:

(1) Making, acquiring and servicing loans and other extensions of credit, pursuant to section 225.25(b)(1) of Regulation Y (12 C.F.R. 225.25(b)(1));

(2) Providing investment and financial advisory services, pursuant to section 225.25(b)(4) of Regulation Y (12 C.F.R. 225.25(b)(4));

(3) Leasing personal or real property or acting as agent, broker, or adviser in leasing such property, pursuant to section 225.25(b)(5) of Regulation Y (12 C.F.R. 225.25(b)(5));

(4) Arranging commercial real estate equity financing, pursuant to section 225.25(b)(14) of Regulation Y (12 C.F.R. 225.25(b)(14));

(5) Providing discount and full-service securities brokerage services, pursuant to section 225.25(b)(15) of Regulation Y (12 C.F.R. 225.25(b)(15));

(6) Underwriting and dealing in obligations of the United States, general obligations of states and their political subdivisions, and other obligations in which state member banks may underwrite and deal under 12 U.S.C. §§ 335 and 24(7) (''bank-eligible securities''), pursuant to section 225.25(b)(16) of Regulation Y (12 C.F.R. 225.25(b)(16));

(7) Acting as a futures commission merchant (''FCM''), pursuant to section 225.25(b)(18) of Regulation Y (12 C.F.R. 225.25(b)(18));

(8) Providing investment advice on financial futures and options on futures, pursuant to section 225.25(b)(19) of Regulation Y (12 C.F.R. 225.25(b)(19));

(9) Underwriting and dealing in, to a limited extent, certain municipal revenue bonds (including certain unrated and ''private ownership'' municipal revenue bonds), 1–4 family mortgage-related securities, consumer receivable-related securities, and commercial paper (collectively, ''bank- ineligible securities'');

(10) Acting as agent in the private placement of all types of securities, and buying and selling all types of securities on the order of customers as a ''riskless principal'';

(11) Trading for its own account in:

(i) Gold and silver bullion, bars, rounds, and coins (''precious metals''); and

(ii) Forwards, options, futures, and options on futures contracts for such precious metals for purposes of hedging positions in the underlying precious metals;

(12) Trading for its own account in foreign exchange spot, forwards, futures, options, and options on futures contracts for purposes other than hedging; and

(13) Acting as originator, principal, broker, agent, or adviser to institutional customers with respect to interest rate and currency swaps and related swap derivative products.[1]

Company would conduct these activities worldwide.

Notice of this proposal, affording interested persons an opportunity to submit comments, has been published (61 *Federal Register* 41,161 (1996)). The time for filing comments has expired, and the Board has considered the proposal and all comments received in light of the factors set forth in section 4(c)(8) of the BHC Act.

NatWest, with total consolidated assets of approximately $257.8 billion, is the second largest banking organization in England.[2] In the United States, NatWest operates branches in New York, New York, and Chicago, Illinois, an agency in Los Angeles, California, and a representative office in Houston, Texas. NatWest also controls several subsidiaries that engage in various nonbanking activities in the United States.

Company is a nonbanking company, currently owned by The Long-Term Credit Bank of Japan, Limited, Tokyo, Japan, that engages in a variety of securities-related, advisory and other nonbanking activities worldwide. Company's principal subsidiary, Greenwich Capital Markets, Inc. (''GCM''), is, and will continue to be, a broker-dealer registered with the Securities and Exchange Commission (''SEC'') under the Securities Exchange Act of 1934 (15 U.S.C. § 78a *et seq.*) and a member of the National Association of Securities Dealers (''NASD''). In addition, GCM is, and will continue to be, registered as an FCM with the Commodity Futures Trading Commission (''CFTC'') under the Commodity Exchange Act (7 U.S.C. § 1 *et seq.*). Accordingly, GCM will be subject to the recordkeeping and reporting obligations, fiduciary standards, and other requirements of the Securities Exchange Act, the Commodity Exchange Act, the SEC, CFTC, and NASD.

Activities Approved by Regulation

The Board previously has determined by regulation that the proposed lending, investment and financial advisory,

1. As used herein, the term ''swap derivative products'' means caps, floors, collars, and options on swaps, caps, floors, and collars.

2. Asset and ranking data are as of December 31, 1995, and use exchange rates then in effect.

leasing, commercial real estate equity financing arranging, securities brokerage, bank-eligible underwriting and dealing, FCM, and futures advisory activities are so closely related to banking as to be a proper incident thereto within the meaning of section 4(c)(8) of the BHC Act.[3] NatWest proposes to conduct these activities in accordance with the Board's regulations and prior Board decisions relating to these activities.[4]

Underwriting and Dealing in Bank-Ineligible Securities

The Board has determined that, subject to the prudential framework of limitations established in previous decisions to address the potential for conflicts of interests, unsound banking practices, or other adverse effects, the proposed activities of underwriting and dealing in bank-ineligible securities are so closely related to banking as to be a proper incident thereto within the meaning of section 4(c)(8) of the BHC Act.[5] NatWest has committed that Company will conduct the proposed underwriting and dealing activities using the same methods and procedures and subject to the same prudential limitations established by the Board in the Section 20 Orders.

The Board also has determined that the conduct of these securities underwriting and dealing activities is consistent with section 20 of the Glass–Steagall Act (12 U.S.C. § 377), provided that the company engaged in the underwriting and dealing activities derives no more than 10 percent of its total gross revenue from underwriting and dealing in bank-ineligible securities over any two-year period. The Board subsequently modified that prudential framework in the case of a foreign banking organization to take into account principles of national treatment and the Board's policy not to extend U.S. Bank supervisory standards extraterritorially.[6] NatWest has committed that Company will conduct its underwriting and dealing activities in bank-ineligible securities subject to the 10-percent revenue test and the prudential limitations established by the Board in its *Sanwa* Order.[7]

Private Placement and "Riskless Principal" Activities

Private placement involves the placement of new issues of securities with a limited number of sophisticated purchasers in a nonpublic offering. A financial intermediary in a private placement transaction acts solely as an agent of the issuer in soliciting purchasers and does not purchase the securities and attempt to resell them. Securities that are privately placed are not subject to the registration requirements of the Securities Act of 1933, and are offered only to financially sophisticated institutions and individuals and not to the public. Company will not privately place registered securities and will only place securities with customers that qualify as accredited investors.

"Riskless principal" is the term used in the securities business to refer to a transaction in which a broker-dealer, after receiving an order to buy (or sell) a security for a customer, purchases (or sells) the security for its own account to offset a contemporaneous sale to (or purchase from) the customer.[8] Riskless principal transactions are understood in the industry to include only transactions in the secondary market. Thus, Company would not act as a riskless principal in selling bank-ineligible securities at the order of a customer that is the issuer of the securities to be sold, or in any transaction where Company has a contractual agreement to place the securities as agent of the issuer. Company also would not act as a riskless principal in any transaction involving a bank-ineligible security for which it or an affiliate makes a market.

The Board has determined that, subject to the limitations established by the Board in prior orders, the proposed private placement and riskless principal activities are so closely related to banking as to be a proper incident thereto within the meaning of section 4(c)(8) of the BHC Act.[9] The Board also has determined that acting as agent in the private placement of securities, and purchasing and selling securities on the order of investors as a riskless principal, do not constitute underwriting and dealing in securities for purposes of section 20 of the Glass–Steagall Act, and that revenue derived from these activities is not subject to the

3. *See* 12 C.F.R. 225.25(b)(1), (4), (5), (14), (15), (16), (18), and (19).

4. Because Company would provide investment advisory and brokerage services with respect to ineligible securities that it may hold as a principal, NatWest has committed that Company will inform its customers at the commencement of the relationship that, as a general matter, it may be a principal or may be engaged in underwriting with respect to, or may purchase from an affiliate, those securities for which brokerage or advisory services are provided. In addition, NatWest has committed that the confirmations sent by Company to customers will state whether Company acted as agent or as principal in the transaction. *See PNC Financial Corp,* 75 *Federal Reserve Bulletin* 396 (1989); *Bankers Trust New York Company,* 74 *Federal Reserve Bulletin* 695 (1988).

5. *See Citicorp, et al.,* 73 *Federal Reserve Bulletin* 473 (1987), *aff'd sub nom. Securities Industry Ass'n v. Board of Governors of the Federal Reserve System,* 839 F.2d 47 (2d Cir.), *cert. denied,* 486 U.S. 1059 (1988); and *Chemical New York Corporation, et al.,* 73 *Federal Reserve Bulletin* 731 (1987), as modified by *Order Approving Modifications to Section 20 Orders,* 75 *Federal Reserve Bulletin* 751 (1989) (collectively, "Section 20 Orders").

6. *The Sanwa Bank, Limited,* 76 *Federal Reserve Bulletin* 568 (1990) ("Sanwa"); *The Toronto-Dominion Bank,* 76 *Federal Reserve Bulletin* 573 (1990).

7. The Board notes that lending to affiliates by U.S. branches and agencies of foreign banks is not restricted by section 23A of the Federal Reserve Act. In view of the limited nature of these activities, the Board does not believe that the record at this time would require extending the restrictions of section 23A to NatWest's U.S. branches and agencies. The Board, however, reserves the right to require that NatWest's U.S. branches and agencies adhere to the restrictions of section 23A should circumstances change to make such a requirement appropriate.

8. *See* SEC Rule 10b-10(a)(8)(i) (17 C.F.R. 240.10b-10(a)(8)(i)). The Board notes that GCM, as a registered broker-dealer, must conduct its riskless principal activities in accordance with the customer disclosure and other requirements of the federal securities laws.

9. *See J.P. Morgan & Company Incorporated,* 76 *Federal Reserve Bulletin* 26 (1990) ("*J.P. Morgan*"); *Bankers Trust New York Corporation, 75 Federal Reserve Bulletin* 829 (1989) ("*Bankers Trust*").

10-percent revenue limitation on bank-ineligible securities underwriting and dealing.[10]

NatWest has committed that Company will conduct its private placement activities using the same methods and procedures and subject to the same prudential limitations as those established by the Board in *Bankers Trust* and *J.P. Morgan,*[11] including the comprehensive framework of restrictions imposed by the Board in connection with underwriting and dealing in bank-ineligible securities, which were designed to avoid potential conflicts of interests, unsound banking practices, and other adverse effects. NatWest also has committed that Company will conduct its riskless principal activities subject to the limitations previously established by the Board.[12]

Precious Metal and Foreign Exchange Activities

NatWest proposes that Company trade for its own account in gold and silver bullion, bars, rounds, and coins, and forwards, options, futures, and options on futures contracts for such precious metals for purposes of hedging positions in the underlying precious metals. NatWest also proposes that Company trade for its own account in foreign exchange spot, forward, futures, options and options on futures transactions for purposes other than hedging. The Board previously has determined that the proposed precious metals activities are closely related to banking and permissible for bank holding companies under section 4(c)(8) of the BHC Act.[13] The Board also previously has approved the proposed foreign exchange-related activities subject to certain limitations, and NatWest has committed that Company will conduct its foreign exchange-related activities in accordance with the limitations established by the Board.[14]

Swap Activities

NatWest proposes that Company act as originator, principal, broker, agent, or adviser to institutional customers with respect to interest rate and currency swaps and related swap derivative products. The Board previously has determined that the proposed swap activities are closely related to banking and permissible for bank holding companies under section 4(c)(8) of the BHC Act.[15] NatWest has committed that Company will conducts its swap activities in accordance with the limitations established by the Board in previous decisions.[16]

Proper Incident to Banking Standard

In order to approve this proposal, the Board also must determine that the proposed activities are a proper incident to banking, that is, that the proposal ''can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices.''[17]

As part of the Board's evaluation of these factors, the Board considers the financial and managerial resources of the notificant and its subsidiaries and the effect the transaction would have on such resources.[18] The Board notes that NatWest's capital ratios satisfy applicable risk-based capital standards established under the Basle Accord and are considered equivalent to the capital levels that would be required of a U.S. banking organization. The Board also has reviewed the capitalization of NatWest and Company in accordance with the standards set forth in the Section 20 Orders and finds the capitalization of each to be consistent with approval. The determination of the capitalization of Company is based on all the facts of record, including NatWest's projections of the volume of Company's underwriting and dealing activities in bank-ineligible securities. Based on all the facts of record, the Board concludes that financial and managerial considerations are consistent with approval of the proposal.

In considering the potential adverse effects of the proposal, the Board has found that there is no evidence in the

10. *See Bankers Trust.*

11. Among the prudential limitations discussed more fully in *Bankers Trust* and *J.P. Morgan* are that Company will not privately place open-end investment company securities or securities of investment companies that are advised by NatWest or any of its affiliates. In addition, Company will make no general solicitation or general advertising for securities it places.

12. *See The Bank of New York Company, Inc.,* 82 *Federal Reserve Bulletin* 748 (1996). Neither Company nor its affiliates will hold themselves out as making a market in the bank-ineligible securities that Company buys and sells as riskless principal, or enter quotes for specific bank-ineligible securities in any dealer quotation system in connection with Company's riskless principal transactions, except that Company and its affiliates may enter bid or ask quotations, or publish ''offering wanted'' or ''bid wanted'' notices on trading systems other than NASDAQ or an exchange, if Company or the affiliate does not enter price quotations on different sides of the market for a particular security for two business days. In other words, Company or its affiliate must wait at least two business days after entering a ''bid'' quote on a security before entering an ''ask'' quote on the same security and vice versa. Company will not act as riskless principal for registered investment company securities or for any securities of investment companies that are advised by NatWest or its affiliates. In addition, because Company proposes to provide riskless principal services in combination with investment advisory services, Company will conduct its riskless principal activities in accordance with the limitations established by the Board for the full-service brokerage activities of bank holding companies. *See* 12 C.F.R. 225.25(b)(15)(ii).

13. *See Midland Bank PLC,* 76 *Federal Reserve Bulletin* 860 (1990).

14. *See The Long-Term Credit Bank of Japan, Limited, 79 Federal Reserve Bulletin* 347 (1993); *The Hongkong and Shanghai Banking Corporation,* 75 *Federal Reserve Bulletin* 217 (1989).

15. *See The Long-Term Credit Bank of Japan, Limited,* 79 *Federal Reserve Bulletin* 345 (1993).

16. *See C&S/Sovran Corporation,* 76 *Federal Reserve Bulletin* 857 (1990); *The Sumitomo Bank, Limited,* 75 *Federal Reserve Bulletin* 582 (1989).

17. 12 U.S.C. § 1843(c)(8).

18. *See* 12 C.F.R. 225.24; *see also The Fuji Bank, Limited,* 75 *Federal Reserve Bulletin* 94 (1989); *Bayerische Vereinsbank AG,* 73 *Federal Reserve Bulletin* 155 (1987).

record to indicate that consummation of the proposal would result in any significantly adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. In addition, the record indicates that there are numerous providers of these nonbanking services.

Based on the foregoing and all other facts of record, the Board has determined that under the framework and conditions established by the Board in this and prior decisions, consummation of the proposal is not likely to result in significantly adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. The Board expects, moreover, that consummation of the proposal would provide added convenience, a broader array of products, and improved services to NatWest's customers. The Board has determined, therefore, that the performance of the proposed activities by NatWest can reasonably be expected to produce public benefits that outweigh possible adverse effects under the proper incident to banking standard of section 4(c)(8) of the BHC Act.

Accordingly, and for the reasons set forth in this order and in the Section 20 Orders, the Board has concluded that NatWest's proposal to engage in the proposed activities is consistent with the Glass–Steagall Act, and that the proposed activities are so closely related to banking as to be proper incidents thereto within the meaning of section 4(c)(8) of the BHC Act, provided that NatWest limits Company's activities as specified in this order and the Section 20 Orders.

On the basis of all the facts of record, the Board has determined to, and hereby does, approve this notice subject to all the terms and conditions discussed in this order and in the Section 20 Orders. The Board's approval of this proposal extends only to activities conducted within the limitations of those orders and this order, including the Board's reservation of authority to establish additional limitations to ensure that Company's activities are consistent with safety and soundness, avoiding conflicts of interests, and other relevant considerations under the BHC Act. Underwriting and dealing in any manner other than as approved in this order and the Section 20 Orders is not authorized for Company.

The Board's determination also is subject to all the terms and conditions set forth in Regulation Y, including those in sections 225.7 and 225.23(g) (12 C.F.R. 225.7 and 225.23(g)), and to the Board's authority to require modification or termination of the activities of a bank holding company or any of its subsidiaries as the Board finds necessary to assure compliance with and to prevent evasion of the provisions of the BHC Act and the Board's regulations and orders issued thereunder. The Board's decision is specifically conditioned on compliance by NatWest with all the commitments made in connection with this notice, including the commitments discussed in this order and the conditions set forth in the Board regulations and orders noted above. The commitments and conditions shall be deemed to be conditions imposed in writing by the Board in connection with its findings and decisions, and may be enforced in proceedings under applicable law.

This transaction shall not be consummated later than three months after the effective date of this order unless such period is extended for good cause by the Board or the Federal Reserve Bank of New York, acting pursuant to delegated authority.

By order of the Board of Governors, effective September 19, 1996.

Voting for this action: Chairman Greenspan and Governors Kelley, Lindsey, Phillips, Yellen, and Meyer. Absent and not voting: Vice Chair Rivlin.

JENNIFER J. JOHNSON
Deputy Secretary of the Board

Orders Issued Under Sections 3 and 4 of the Bank Holding Company Act

Grupo Financiero Banamex Accival, S.A. de C.V. Mexico City, Mexico

Banco National de México, S.A. Mexico City, Mexico

Banamex USA Bancorp Los Angeles, California

Order Approving the Formation of a Bank Holding Company and a Proposal to Engage in Certain Securities Activities

Grupo Financiero Banamex Accival, S.A. de C.V., Mexico City, Mexico (''Banacci''), has requested the Board's approval under section 3(a)(1) of the Bank Holding Company Act (''BHC Act'') (12 U.S.C. § 1842(a)(1)) to become a bank holding company within the meaning of the BHC Act through its ownership of 99.9 percent of the voting shares of Banco National de México, S.A., Mexico City, Mexico (''Banamex''), a foreign bank registered as a bank holding company, and thereby to retain all the voting shares of Banamex USA Bancorp, Los Angeles, California (''Bancorp''), and its subsidiary bank, California Commerce Bank (''CCB''), Los Angeles, California (''CCB'').[1]

Banacci also has requested the Board's approval under section 4(c)(8) of the BHC Act (12 U.S.C. § 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) to retain indirectly all the voting shares of ACCI Securities, Inc, New York, New York (''ACCI''),[2] and

1. In 1991, Banacci acquired control of Banamex as part of the Mexico's privatization of its banking system. The shares of Bancorp were placed in a voting trust administered by an independent trustee until the Board could act on an application by Banacci under the BHC Act to retain indirect control of CCB.

2. Banacci acquired ACCI through its wholly owned subsidiary, Acciones y Valores de México, S.A. de C.V., Mexico City, Mexico, in

thereby engage in the following securities-related activities:

(1) Providing full-service securities brokerage services, pursuant to section 225.25(b)(15) of Regulation Y (12 C.F.R. 225.25(b)(15));
(2) Acting as agent in the private placement of all types of securities; and
(3) Buying and selling all types of securities on the order of customers as a ''riskless principal.''

Notice of the proposal, affording interested persons an opportunity to submit comments, has been published (57 *Federal Register* 1484 (1992); 59 *Federal Register* 1400 (1994); 60 *Federal Register* 58,361 and 66,275 (1995)). The time for filing comments has expired, and the Board has considered the application and notice and all comments received in light of the factors set forth in sections 3 and 4 of the BHC Act.

Banamex, with total assets equivalent to approximately $29 billion, is the largest commercial banking organization in Mexico.[3] CCB is the 37th largest commercial banking organization in California, controlling deposits of $423.4 million, representing less than 1 percent of all deposits in commercial banking organizations in the state.[4] In addition to CCB, Banamex operates agencies in New York, New York; Los Angeles, California; and Houston, Texas; and a representative office in Houston, Texas.

Home Country Supervisory Considerations

In order to approve an application involving a foreign bank to acquire a U.S. bank or bank holding company, the BHC Act and Regulation Y require the Board to determine that the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor.[5] The Board also must determine that the foreign bank has provided adequate assurances that it will make available to the Board such information on its operations and activities and those of its affiliates that the Board deems appropriate to determine and enforce compliance with applicable law.[6]

The Board considers a foreign bank to be subject to comprehensive supervision or regulation on a consolidated basis if the Board determines that its home country supervisor receives sufficient information on the foreign bank's worldwide operations, including its relationship to any affiliate, to assess the foreign bank's overall financial condition and compliance with law and regulation.[7]

The National Banking and Securities Commission (''CNBV''), an agency of the Ministry of Finance (''MOF''), was formed in 1995 by combining Mexico's banking and securities supervisory authorities.[8] CNBV functions as Banamex's primary home country supervisor and is responsible for enforcing Mexican banking and securities laws.[9] Since 1990, the CNBV has been substantially revising Mexico's banking supervisory framework through the issuance of supervisory and regulatory requirements that seek to ensure the safe and sound operations of Mexican banks.

Recently, many additional steps have been taken to enhance the supervisory function. These include:

(1) Improvement in the quality of required regulatory financial reporting;
(2) Strengthening the monitoring of banks' conditions by conducting annual on-site examinations that focus on risk management and management information systems;
(3) Changes in the asset classification process and related loan loss reserve calculation to provide a better assessment of asset quality; and
(4) Promotion of a closer exchange of information with foreign supervisory authorities.

In addition, in 1994, CNBV entered into a Financial Technical Assistance Program with the World Bank to strengthen bank supervision. The program is intended to

September 1991. The North American Free Trade Agreement (''NAFTA'') permits a Mexican financial group formed before the effective date of the NAFTA, like Banacci, which lawfully acquired a Mexican bank and a Mexican securities firm that owns or controls a United States securities company, to continue to engage in the securities activities of the United States company as of the acquisition date, subject to certain restrictions, for up to five years from the acquisition date.

3. Asset data are as of June 30, 1996.

4. State deposit and ranking data are as of June 30, 1995.

5. *See* 12 U.S.C. § 1842(c)(3)(B); 12 C.F.R. 225.13(b)(5). The Board received comments from Inner City Press/Community on the Move (''Protestant'') asserting, without providing any substantiation, that the supervision of Banacci and Banamex under Mexico's bank regulatory system was inconsistent with approval of the proposal.

6. *See* 12 U.S.C. § 1842(c)(3)(A); 12 C.F.R. 225.13(b)(4).

7. In assessing this standard, the Board considers, among other factors, the extent to which the home country supervisor:

(i) Ensures that the foreign bank has adequate procedures for monitoring and controlling its activities worldwide;
(ii) Obtains information on the condition of the foreign bank and its subsidiaries and offices outside the home country through regular reports of examination, audit reports, or otherwise;
(iii) Obtains information on the dealings and relationships between the foreign bank and its affiliates, both foreign and domestic;
(iv) Receives from the foreign bank financial reports that are consolidated on a worldwide basis, or comparable information that permits analysis of the foreign bank's financial condition on a worldwide, consolidated basis; and
(v) Evaluates prudential standards, such as capital adequacy and risk asset exposure, on a worldwide basis. These are indicia of comprehensive, consolidated supervision. No single factor is essential, and other elements may inform the Board's determination. 12 C.F.R. 211.24(c)(1).

8. References to CNBV before 1995 are intended to refer to the previous banking supervisory agency, the National Banking Commission.

9. CNBV also is the primary supervisor of Banacci's securities subsidiaries and of the holding company itself. The bank also receives additional oversight by the MOF and the Bank of Mexico, the central bank. The MOF is responsible for licensing commercial banking activities and regulates the structure and operation of financial groups and certain aspects of banking and brokerage operations. The Bank of Mexico regulates foreign currency activities and acts as a reserve bank and a treasurer for the federal government.

develop a modern regulatory and legal framework for financial institutions and groups operating in Mexico.

CNBV obtains information on the operations of Banamex primarily through on-site examinations and periodic reports. CNBV conducts annual on-site full-scope examinations of Mexican banks, which include a review of asset quality, capital adequacy, liquidity, earnings, concentration of risks, and international banking operations. CNBV requires banks to submit numerous periodic reports on their worldwide operations, including daily balance sheets, weekly asset/liability positions, foreign currency asset and liability reports, and insider transaction reports.[10]

CNBV also receives reports prepared by external auditors who generally conduct annual audits of Banamex's subsidiaries and branches. The auditing firm is responsible for reviewing the bank's annual financial statements, including assessing the bank's asset quality and internal controls.

Mexican banks, including Banamex, are subject to certain restrictions with respect to transactions with affiliates and investments in other companies. Loans to shareholders owning 1 percent or more of the bank's shares, to a board member or board member's relative, or to certain other related parties must be approved by the bank's directors. In addition, the loans must be reported to the CNBV. Total related party transactions may not exceed the bank's net capital.

With respect to monitoring its worldwide operations, Banamex's internal audit department conducts annual audits of its domestic and foreign offices. The audit reports are reviewed by the CNBV during its examinations.

Based on all the facts of record, the Board concludes that, for purposes of the BHC Act, Banamex is subject to comprehensive supervision on a consolidated basis by its home country supervisor.

The Board has reviewed the restrictions on disclosure of information in certain jurisdictions where Banacci and Banamex operate and have communicated with the relevant government authorities concerning access to information. Banacci and Banamex have committed to make available to the Board such information on their operations or activities and those of any of their affiliates that the Board deems necessary to determine and enforce compliance with the International Banking Act, the BHC Act, as amended, and other applicable federal law. To the extent that the provision of such information to the Board may be prohibited or impeded by law, Banacci and Banamex have committed to cooperate with the Board in obtaining any necessary consents or waivers that might be required from third parties for disclosure. In light of these commitments and other facts of record, and subject to the condition described below, the Board concludes that Banacci and Banamex have provided adequate assurances of access to any necessary information the Board may request.

Other Factors under the BHC Act

The BHC Act also requires the Board to consider the financial and managerial resources and future prospects of the companies and banks involved, the convenience and needs of the community to be served, and certain other supervisory factors.

A. Supervisory Factors

The Board has carefully considered the financial and managerial resources and future prospects of Banacci, Banamex, CCB, and their subsidiaries, and other supervisory factors, in light of all the facts of record. Although there are differences between Mexican and U.S. accounting practices, Banamex's capital under Mexican generally accepted accounting practices exceeds the minimum standards in the Basle Accord.[11] Banamex's capital also is regarded as equivalent to the capital that would be required of a U.S. banking organization in the context of a nonexpansionary proposal to retain an existing subsidiary.

As a result of the devaluation of the Mexican peso in 1994, however, the financial condition of Banamex has experienced weaknesses, particularly in asset quality. The Board believes that a number of considerations mitigate the effect of Banamex's financial condition on this proposal.[12] Banamex has controlled CCB for approximately 18 years and has maintained its U.S. operations in overall satisfactory financial condition. In addition, Banamex has participated in programs initiated by the government of Mexico that have slowed the growth of asset quality deterioration and improved its capital position. These programs include a debtor support program whereby certain loans are restructured at lower interest rates and a loan purchase/recapitalization program whereby the government of Mexico purchases problem bank loans subject to a commitment by private investors to raise new capital. Banacci has provided a significant portion of the additional capital raised by Banamex under this recapitalization requirement, and generally has demonstrated an ability to serve as a source of strength for its banking operations.[13] The Board

10. CNBV is in the process of revising the accounting standards used by Mexican banks to make them more consistent with international accounting standards. The changes are expected to improve the quality of disclosure in financial statements on asset quality, investments, capitalization, and earnings performance. In addition, consolidated financial statements will be required for the parent company and all the parent company's financially related subsidiaries. Although the changes have not yet been made, the CNBV supplements its review of the reports through the examination process and other techniques, which allow an assessment of the consolidated condition of the organization.

11. Mexican banks are required to maintain certain minimum capital ratios. Although the calculation of the minimum ratios does not compare directly with the methods used under the Basle Accord, the ratios are calculated on a risk-based basis. Banamex currently is in compliance with the Mexican risk-based capital requirements.

12. Protestant notes that Banamex was rated "D+" for financial strength by Moody's Investors Service and questions whether Banacci has sufficient capital to serve as a source of strength for CCB.

13. Under the loan purchase/recapitalization program, Banamex is required to increase its capitalization by approximately $1.1 billion by

notes, moreover, that Banamex's capital would not be diminished as a result of this proposal and that CCB represents a small portion of Banamex's total assets.[14]

Based on these and all the facts of record, the Board concludes that the supervisory factors under the BHC Act, including financial and managerial resources, are consistent with approval of the proposal.

B. Convenience and Needs Factor

The Board has long held that consideration of the convenience and needs factor includes a review of the records of the relevant depository institutions under the Community Reinvestment Act (12 U.S.C. § 2901 *et seq.*) (''CRA''). As provided in the CRA, the Board has evaluated this factor in light of examinations by the primary federal supervisor of the CRA performance record of the relevant institution.

The Board also has carefully considered comments from Protestant maintaining that CCB has failed to assist in meeting the credit needs of its delineated community and to comply with applicable fair lending laws. Protestant uses the less-than-satisfactory performance evaluations of CCB by its primary federal supervisor, the Federal Deposit Insurance Corporation (''FDIC''), in 1993 and 1994 to support its contentions.

After Protestant's comments were received, CCB received a rating of ''satisfactory'' from the FDIC in its most recent CRA performance evaluation, as of September 5, 1995 (''1995 Examination''). The Board believes that an institution's most recent CRA performance evaluation is a particularly important consideration in the applications process because it represents a detailed on-site evaluation of the institutions overall record of performance under the CRA by its primary federal supervisor.[15] In addition, the Board considers an institution's policies and practices for compliance with applicable fair lending laws and takes into account information on lending activities that assist in meeting the credit needs of low- to moderate-income neighborhoods.

The 1995 Examination found no evidence of prohibited discrimination or other illegal credit practices. Moreover, examiners found no evidence of policies or practices intended to discourage applications for the types of credit listed in CCB's CRA statement.[16]

CCB is primarily an international wholesale bank that does not directly originate long-term residential mortgage or home improvement loans. The 1995 Examination, however, found that the bank assisted in meeting the credit needs of its delineated communities by purchasing home mortgage loans and by providing mortgage warehouse lines of credit to unaffiliated mortgage companies that are active lenders in the Veteran's Administration and Federal Home Administration lending programs. In the first eight months of 1995, CCB provided $4.6 million through those mortgage lines of credit to finance the purchase of 36 homes. Sixty-four percent of the homes were in low- to moderate-income census tracts, and 78 percent were purchased by minority borrowers. Examiners also noted favorably CCB's efforts to increase consumer lending to low- and moderate-income and minority borrowers within its delineated communities.

In addition, examiners found that, in the time since its previous examinations, CCB had demonstrated an increased effort to ascertain its communities' credit needs, which resulted in CCB's participation with several consortiums created to help meet the credit needs of low- to moderate-income residents and businesses. For example, examiners noted that CCB had funded $962,000 of a $2.34 million line of credit to California Community Reinvestment Corporation, which provides long-term financing for multi-family housing for low- to moderate-income families in California. CCB also committed to invest in the California Equity Fund 1995 Limited Partnership, a $75 million pooled fund to provide equity capital for the construction of approximately 900 affordable homes throughout California in 1995 and 1996. Examiners noted that CCB made a $50,000 equity investment in and a $408,000 line of credit commitment to the California Economic Development Lending Initiative, a small business lending consortium. In addition, CCB made a $40,000 equity investment in the Southern California Business Development Corporation, a multi-bank community development corporation that invests in small businesses in South Central Los Angeles that do not qualify for conventional bank financing.

Based on all the facts of record, including the Protestant's comments, and for the reasons discussed above, the Board concludes that convenience and needs considerations are consistent with approval of this proposal.

Nonbanking Activities

Banacci also has filed notice, pursuant to section 4(c)(8) of the BHC Act, to engage through Company in full-service securities brokerage, private placement, and riskless principal activities. The Board notes that ACCI is a registered

the end of 1996. As of July 31, 1996, Banamex had completed 80 percent of the required capitalization. Banamex has sold approximately $1.9 billion of commercial loans, net of reserves, to Fobaproa, the Mexican banking insurance fund in exchange for Mexican government securities.

14. CCB represents less than 3 percent of Banamex's total assets.

15. The Board notes that the Statement of the Federal Financial Supervisory Agencies Regarding the CRA provides that a CRA examination is an important and often controlling factor in the consideration of an institution's CRA record and that reports of these examinations will be given great weight in the applications process. 54 *Federal Register* 13,742, 13,745 (1989).

16. Examiners noted certain technical violations of the fair lending laws, which they did not consider to reflect negatively on CCB's lending practices.

broker-dealer with the Securities and Exchange Commission (''SEC'') and is a member of the National Association of Securities Dealers, Inc. (''NASD''). ACCI, therefore, is subject to the recordkeeping, reporting, and fiduciary standards of the Securities Exchange Act of 1934 (15 U.S.C. § 78a *et seq.*), the SEC, and the NASD.

Section 4(c)(8) of the BHC Act provides that a bank holding company may, with Board approval, engage in any activity that the Board determines to be ''so closely related to banking or managing or controlling banks as to be a proper incident thereto.''[17] As noted above, the Board has determined by regulation that the proposed full-service securities brokerage activities are closely related to banking for purposes of section 4(c)(8) of the BHC Act.[18] Banacci has committed that ACCI will conduct these activities in accordance with the Board's regulations and orders approving these activities for bank holding companies.

Private Placement and ''Riskless Principal'' Activities

Private placement involves the placement of new issues of securities with a limited number of sophisticated purchasers in a nonpublic offering. A financial intermediary in a private placement transaction acts solely as an agent of the issuer in soliciting purchasers and does not purchase the securities and attempt to resell them. Securities that are privately placed are not subject to the registration requirements of the Securities Act of 1933 and are offered only to financially sophisticated institutions and individuals and not to the public. ACCI will not privately place registered securities and will only place securities with customers that qualify as accredited investors.

''Riskless principal'' is the term used in the securities business to refer to a transaction in which a broker-dealer, after receiving an order to buy (or sell) a security for a customer, purchases (or sells) the security for its own account to offset a contemporaneous sale to (or purchase from) the customer.[19] ''Riskless principal'' transactions are understood in the industry to include only transactions in the secondary market. ACCI, thus, would not act as a ''riskless principal'' in selling securities on the order of a customer that is the issuer of the securities to be sold or in any transaction in which ACCI or an affiliate has a contractual agreement to place the securities as agent of the issuer. ACCI also would not act as a ''riskless principal'' in any transaction involving a security for which it or an affiliate makes a market.

The Board has determined that, subject to the limitations established by the Board in prior orders, the proposed private placement and riskless principal activities are so closely related to banking as to be a proper incident thereto within the meaning of section 4(c)(8) of the BHC Act.[20] The Board also has determined that acting as agent in the private placement of securities, and purchasing and selling securities on the order of investors as a riskless principal, do not constitute underwriting and dealing in securities for purposes of section 20 of the Glass–Steagall Act, and that revenue derived from these activities is not subject to the 10-percent revenue limitation on bank-ineligible securities underwriting and dealing.[21]

Banacci has committed that ACCI will conduct its private placement activities using the same methods and procedures and subject to the same prudential limitations as those established by the Board in *Bankers Trust* and *J.P. Morgan*, as modified to reflect the status of Banacci as a foreign banking organization.[22] The limitations include the comprehensive framework of restrictions imposed by the Board in connection with underwriting and dealing in bank-ineligible securities, which were designed to avoid potential conflicts of interests, unsound banking practices, and other adverse effects. Banacci also has committed that ACCI will conduct its riskless principal activities subject to the limitations previously established by the Board.[23]

Other Considerations

In order to approve this proposal, the Board must determine that the proposed activities are a proper incident to

17. 12 U.S.C. § 1843(c)(8).

18. *See* 12 C.F.R. 225.25(b)(15).

19. *See* SEC Rule 10b-10(a)(8)(i) (17 C.F.R. 240.10b-10(a)(8)(i)). The Board notes that, as a registered broker-dealer, ACCI must conduct its riskless principal activities in accordance with the customer disclosure and other requirements of the federal securities laws.

20. *See The Bank of New York Company, Inc.,* 82 *Federal Reserve Bulletin* 748 (1996) (''*Bank of New York*''); *J.P. Morgan & Company Inc.,* 76 *Federal Reserve Bulletin* 26 (1990) (''*J.P. Morgan*''); *Bankers Trust New York Corporation,* 75 *Federal Reserve Bulletin* 829 (1989) (''*Bankers Trust*'').

21. *See Bankers Trust.*

22. *See The Sumitomo Bank, Limited,* 77 *Federal Reserve Bulletin* 339 (1991); *Creditanstalt-Bankverein,* 77 *Federal Reserve Bulletin* 183 (1991); *The Royal Bank of Scotland Group PLC,* 76 *Federal Reserve Bulletin* 866 (1990); *Canadian Imperial Bank of Commerce,* 76 *Federal Reserve Bulletin* 158 (1990). Among the prudential limitations discussed more fully in these orders are that Banacci has committed that ACCI will not privately place registered investment company securities or securities of investment companies that are sponsored or advised by Banacci or any of its affiliates. In addition, ACCI will make no general solicitation or general advertising for securities it places.

23. *See Bank of New York.* ACCI will not hold itself out as making a market in the bank-ineligible securities that ACCI buys and sells as riskless principal, or enter quotes for specific bank-ineligible securities in any dealer quotation system in connection with ACCI's riskless principal transactions, except that ACCI may enter bid or ask quotations, or publish ''bid wanted'' or ''offering wanted'' notices on trading systems other than NASDAQ or an exchange, if ACCI does not enter price quotations on different sides of the market for a particular security for two business days. In other words, ACCI must wait at least two business days after entering a ''bid'' quote on a security before entering an ''ask'' quote on the same security and *vice versa.* ACCI will not act as riskless principal for registered investment company securities or for any securities of investments companies that are advised by ACCI or its affiliates. In addition, if ACCI provides riskless principal services in combination with investment advisory services in the U.S., it will conduct its riskless principal activities in accordance with the limitations established by the Board for the full-service brokerage activities of bank holding companies. *See* 12 C.F.R. 225.25(b)(15)(ii).

banking, that is, that the performance of the proposed activities by ACCI can reasonably be expected to produce public benefits that would outweigh possible adverse effects.[24]

In evaluating these factors, the Board considers the financial and managerial resources of the notificant and its subsidiaries, and the effect the proposed transaction would have on those resources.[25] Based on all the facts of record, the Board concludes that financial and managerial considerations are consistent with approval of this notice. For the reasons discussed above, and in reliance on all the commitments made in connection with this notice and the conditions discussed in this order, the Board concludes that this proposal is not likely to result in significantly adverse effects, such as decreased or unfair competition, conflicts of interest, unsound banking practices, undue concentration of resources, or other adverse effects. Moreover, the Board expects that the proposal would expand the investment services for and provide greater convenience to, Banacci's customers and increase the level of competition among existing providers of these services. The Board has determined, therefore, that the performance of the proposed activities by ACCI can reasonably be expected to produce public benefits that outweigh possible adverse effects under the proper incident to banking standard of section 4(c)(8) of the BHC Act.

Conclusion

Based on the foregoing and all the facts of record, the Board has determined that the application and notice should be, and hereby are, approved. Should any restrictions on access to information on the operations or activities of Banacci and any of its affiliates subsequently interfere with the Board's ability to determine compliance by Banacci or any of its affiliates with applicable federal statutes, the Board may require termination of any of Banacci's direct or indirect activities in the United States.

The Board's approval is specifically conditioned on compliance by Banacci with all the commitments made in connection with this application and notice and on receipt by Banacci of all necessary approvals from state and federal regulators. The Board's determinations on the nonbanking activities are subject to all the terms and conditions set forth in Regulation Y, including those in sections 225.7 and 225.23(g) of Regulation Y (12 C.F.R. 225.7 and 225.23(g)), and to the Board's authority to require such modification or termination of the activities of a bank holding company or any of its subsidiaries as it finds necessary to ensure compliance with or to prevent evasion of the provisions of the BHC Act and the Board's regulations and orders issued thereunder. The commitments and conditions relied on by the Board in reaching this decision are deemed to be conditions imposed in writing by the Board in connection with its findings and decision and, as such, may be enforced in proceedings under applicable law.

By order of the Board of Governors, effective September 9, 1996.

Voting for this action: Chairman Greenspan and Governors Kelley, Lindsey, Phillips, Yellen, and Meyer. Absent and not voting: Vice Chair Rivlin.

JENNIFER J. JOHNSON
Deputy Secretary of the Board

24. 12 U.S.C. § 1843(c)(8).

25. *See* 12 C.F.R. 225.24. *See also The Fuji Bank, Limited,* 75 *Federal Reserve Bulletin* 94 (1989); *Bayerische Vereinsbank AG,* 73 *Federal Reserve Bulletin* 155 (1987).

The Toronto-Dominion Bank
Toronto, Canada

Order Approving an Application to Become a Bank Holding Company and Notices to Acquire Nonbanking Companies

The Toronto-Dominion Bank, Toronto, Canada (''TDB''), a foreign bank subject to the Bank Holding Company Act (''BHC Act''), has requested the Board's approval under section 3 of the BHC Act (12 U.S.C. § 1842) to become a bank holding company by acquiring all the voting shares of Waterhouse Investor Services, Inc., New York (''Waterhouse''), and its wholly owned subsidiary bank, Waterhouse National Bank, White Plains (''WNB''), both in the State of New York.[1] TDB also has requested the Board's approval under section 4(c)(8) of the BHC Act (12 U.S.C. § 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) to acquire the nonbanking subsidiaries of Waterhouse and thereby engage nationwide in certain permissible nonbanking activities.[2]

Notice of the proposal, affording interested persons an opportunity to submit comments, has been published in accordance with the Board's rules (61 *Federal Register* 37,480 and 28,585 (1996)). The time for filing comments has expired, and the Board has considered the proposal and all comments received in light of the factors set forth in sections 3 and 4 of the BHC Act.

TDB, with total consolidated assets of $84.5 billion, is the fifth largest commercial bank in Canada.[3] In the United States, TDB operates a branch in New York, New York, which controls $3.0 billion in deposits, representing ap-

1. TDB proposes to acquire Waterhouse through its wholly owned subsidiary, TD/Oak, Inc., New York, New York, which has also applied under section 3 of the BHC Act to become a bank holding company.

2. Waterhouse owns the following nonbanking subsidiaries, all in New York, New York: Waterhouse Securities, Inc. (''WSI''), Washington Discount Brokerage Corp., and National Investor Services Corp. Each of these companies provides discount brokerage and other securities related services pursuant to 12 C.F.R. 225.25(b)(15)(i). TDB also has applied for approval to acquire a warrant for up to 6.9 percent of the voting shares of Waterhouse, which would become moot on consummation of the proposal.

3. Asset data are as of April 30, 1996, and are based on the average exchange rate applicable in April 1996.

proximately 1.2 percent of total deposits in commercial banks in the state.[4] TDB also owns an agency in Houston, Texas, and representative offices in New York, New York, and Chicago, Illinois. In addition, TDB engages in a broad range of permissible nonbanking activities in the United States through subsidiaries, including underwriting and dealing in debt and equity securities to a limited extent, discount brokerage, and lending.

Waterhouse is the 34th largest commercial banking organization in New York State, controlling deposits of approximately $609 million, representing less than 1 percent of total deposits in commercial banks in the state.[5] Waterhouse also provides discount brokerage and related services primarily to retail customers throughout the United States. On consummation of the proposal, TDB would become the 14th largest commercial bank in New York State, controlling deposits of $3.6 billion.

Competitive Considerations

The BHC Act prohibits the Board from approving an application under section 3 of the BHC Act if the proposal would result in a monopoly, or would substantially lessen competition in any relevant banking market, unless the Board finds that the anticompetitive effects of the proposal are clearly outweighed in the public interest by the probable effect of the proposal in meeting the convenience and needs of the community to be served.

TDB and WNB compete directly in the New York/New Jersey Metropolitan banking market (''New York Metropolitan banking market'').[6] After consummation of this proposal, TDB would control less than 1 percent of the total deposits in commercial banks and savings associations in the New York Metropolitan banking market,[7] and the market would remain unconcentrated as measured by the Herfindahl–Hirschman Index (''HHI'').[8] Numerous competitors also would remain in the market. Accordingly, and based on all the facts of record, the Board has concluded that consummation of this proposal would not have a significantly adverse effect on competition or the concentration of banking resources in any relevant banking market.

Other Factors Under the BHC Act

The BHC Act requires the Board to consider whether a foreign bank is subject to comprehensive supervision and regulation on a consolidated basis by its home country supervisor. The Board also must consider the financial and managerial resources and future prospects of the companies and banks involved, the convenience and needs of the community to be served, and certain other supervisory factors.

A. Supervisory Factors

Under section 3 of the BHC Act, as amended by the Foreign Bank Supervision Enhancement Act of 1991,[9] the Board may not approve an application involving a foreign bank unless the bank is ''subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in the bank's home country.''[10] The Board previously has determined, in applications under the International Banking Act (12 U.S.C. § 3101 *et seq.*) (''IBA'') and the BHC Act, that certain Canadian commercial banks were subject to comprehensive consolidated supervision by their home country authorities.[11] In this case, the Board has determined that TDB is supervised on substantially the same terms and conditions as the other Canadian banks.[12]

4. State data and deposit data for TDB are as of June 30, 1996.

5. State data and deposit data for WNB are as of June 30, 1996.

6. The New York Metropolitan banking market includes New York City; Nassau, Orange, Putnam, Rockland, Suffolk, Sullivan, and Westchester Counties in New York; Bergen, Essex, Hudson, Hunterdon, Middlesex, Monmouth, Morris, Ocean, Passaic, Somerset, Sussex, Union, Warren, and a portion of Mercer Counties in New Jersey; Pike County in Pennsylvania; and portions of Fairfield and Litchfield Counties in Connecticut.

7. Market share data are as of June 30, 1995, except for data for TDB, which are as of June 30, 1996. Market share data are based on calculations in which deposits of thrift institutions are included at 50 percent. The Board previously has indicated that thrift institutions have become, or have the potential to become, significant competitors of commercial banks. *See, e.g., Midwest Financial Group,* 75 *Federal Reserve Bulletin* 386 (1989). Thus, the Board regularly has included thrift deposits in the calculation of market concentration on a 50-percent weighted basis. *See, e.g., First Hawaiian, Inc.,* 77 *Federal Reserve Bulletin* 52 (1991).

8. The HHI would remain unchanged at 735. Under the revised Department of Justice Merger Guidelines, 49 *Federal Register* 26,823 (1984), a market in which the post-merger HHI is below 1000 is considered unconcentrated. The Department of Justice has informed the Board that a bank merger or acquisition generally will not be challenged (in the absence of other factors indicating anticompetitive effects) unless the post-merger HHI is at least 1800 and the merger increases the HHI by more than 200 points. The Justice Department has stated that the higher than normal HHI thresholds for screening bank mergers for anticompetitive effects implicitly recognize the competitive effect of limited-purpose lenders and other non-depository institutions.

9. Pub. L. No. 102–242, § 201 *et seq.* , 105 Stat. 2286 (1991).

10. 12 U.S.C. § 1842(c)(3)(B). As provided in Regulation Y, the Board determines whether a foreign bank is subject to consolidated home country supervision under the standards set forth in Regulation K (International Banking Operations). 12 C.F.R. 225.13(b)(5). Regulation K provides that a foreign bank may be considered subject to consolidated supervision if the Board determines that the bank is supervised or regulated in such a manner that its home country supervisor receives sufficient information on the worldwide operations of the foreign bank, including the relationship of the bank to its affiliates, to assess the foreign bank's overall financial condition and compliance with law and regulation. 12 C.F.R. 211.24(c)(1)(ii).

11. *See National Bank of Canada,* 82 *Federal Reserve Bulletin* 769 (1996); *Bank of Montreal, et al.,* 80 *Federal Reserve Bulletin* 925 (1994) (''*Bank of Montreal*'').

12. In reviewing this factor, the Board has carefully considered comments by Inner City Press/Community on the Move, Bronx, New York (''Protestant'') contending that Canadian financial institutions are not subject to comprehensive supervision on a consolidated basis. In particular, Protestant argues that recent reported regulatory violations and significant trading losses involving a Japanese bank, a Japanese trading firm, and a Swiss bank require the Board to reconsider its previous determinations that Canadian banks are subject to

Based on all the facts of record, the Board has concluded that TDB is subject to comprehensive supervision and regulation on a consolidated basis by its home country supervisor.

The BHC Act also requires the Board to determine that the foreign bank has provided adequate assurances that it will make available to the Board such information on its operations and activities and those of its affiliates that the Board deems appropriate to determine and enforce compliance with the BHC Act. The Board has reviewed the restrictions on disclosure in jurisdictions where TDB has material operations and has communicated with relevant government authorities concerning access to information. TDB has committed that, to the extent not prohibited by applicable law, it will make available to the Board such information on the operations of TDB and any of its affiliates that the Board deems necessary to determine and enforce compliance with the BHC Act, the IBA, and other applicable federal law. TDB also has committed to cooperate with the Board to obtain any waivers or exemptions that may be necessary in order to enable TDB to make any such information available to the Board. In light of these commitments and other facts of record,[13] the Board has concluded that TDB has provided adequate assurances of access to any appropriate information the Board may request. For these reasons, based on all the facts of record and subject to the conditions noted below, the Board has concluded that the supervisory factors it is required to consider under section 3(c)(3) of the BHC Act are consistent with approval.

In considering the financial resources of TDB, the Board notes that TDB must comply with capital standards that conform to the Basle Capital Accord, as implemented by Canadian banking authorities. TDB's capital levels comply with those standards and are considered equivalent to the capital that would be required of a United States banking organization. Moreover, the proposed transaction is relatively small, would involve no significant diminution of capital, and is not expected to have a significantly adverse effect on the financial or managerial resources of TDB, Waterhouse, or WNB. The Board also has carefully considered the managerial resources of TDB in light of all the facts of record including assessment of the bank's managerial resources by Canadian banking authorities.[14] Based on all the facts of record, the Board concludes that considerations relating to the financial and managerial resources and future prospects of the organizations involved are consistent with approval.[15]

B. Convenience and Needs Factor

The Board has long held that consideration of the convenience and needs factor includes a review of the records of the relevant depository institutions under the Community Reinvestment Act (12 U.S.C. § 2901 *et seq.*) (''CRA''). The Office of the Comptroller of the Currency (''OCC''), WNB's primary federal supervisor, has not evaluated the bank's record of CRA performance, and TDB has not controlled an institution subject to evaluation under the CRA for a number of years. In this light, Protestant contends that WNB has an inadequate record of performance under the CRA,[16] and that TDB does not have the capability to improve WNB's record of performance.[17] The Board has carefully reviewed Protestant's comments in light of all the facts of record.[18]

comprehensive supervision on a consolidated basis. Protestant also expresses concern about the conduct of Canadian regulators with respect to certain alleged improper actions involving the takeover of the Maple Leaf Gardens sports arena in Toronto, Canada. Protestant's comments on the trading and other activities of Japanese and Swiss Banks do not relate to the supervision of Canadian financial institutions. TDB denies any improper conduct in the Maple Leaf Gardens transaction, and a lawsuit brought by Canadian authorities related to that transaction has been dismissed.

13. The Board previously has reviewed relevant provisions of confidentiality, secrecy, and other laws in jurisdictions in which TDB has material operations. *See Bank of Montreal; National Bank of Canada.*

14. In weighing the adequacy of the financial and managerial resources, the Board has carefully considered, in light of all the facts of record including information received from Canadian regulatory authorities, certain allegations regarding the involvement of TDB and TDB's senior management in the acquisition of Maple Leaf Gardens, in which TDB acted as a lender and acquired indirectly a limited equity position. The Board also has considered press reports submitted by Protestant regarding certain small-business lending and cost-saving practices of TDB management and damages assessed against TDB for cancelling a line of credit.

15. TDB has notified the Board pursuant to the Depository Institution Management Interlocks Act (12 U.S.C. § 3201) (''DIMIA'') and the Board's Regulation L (12 C.F.R. 212) that the chairman of its board of directors also serves on the board of a diversified savings and loan holding company. Protestant has expressed concerns about this interlock. Based on all the facts of record, including TDB's representation that the officer would not serve on the board of Waterhouse or WNB, the Board concludes that the officer's management functions with TDB ''relate principally to the business outside the United States of a foreign commercial bank.'' 12 C.F.R. 212.2(h)(2). Accordingly, the interlocking official is not a ''management official'' subject to the interlocks prohibition of Regulation L and the DIMIA.

16. Protestant criticizes a number of aspects of WNB's CRA performance, including making allegations that WNB:

(1) Failed to implement the CRA initiatives described in Waterhouse's application to charter WNB in 1994;

(2) Failed to include New York City within its delineated service community;

(3) Failed to meet adequately the needs of its delineated community;

(4) Made flawed attempts to improve its CRA performance through investments in community development projects after this application was filed;

(5) Has lacked a coherent CRA program; and

(6) Has experienced numerous delays in and made frequent changes to its CRA-related strategies and activities.

17. Protestant maintains that TDB lacks recent experience with CRA compliance and that TDB has failed to understand and properly address the CRA performance issues raised during the processing of the application.

18. Protestant contends that WNB's decision to locate in White Plains, rather than in New York, New York, where Waterhouse is located, has a discriminatory impact on low- and moderate-income (''LMI'') and minority communities, which are located primarily elsewhere in the New York Metropolitan banking market. The record

WNB was chartered in 1994 as an ''affinity'' bank to provide banking services primarily to customers who obtained securities-related services from Waterhouse's brokerage subsidiaries nationwide. The bank did not begin actively to market deposit services until May 1995 or to test-market credit card products until December 1995. From December 1995 to June 1996, the amount of deposits held by WNB doubled to approximately $609 million.

During this period of significantly increasing deposits, WNB became eligible for consideration as a ''limited purpose bank'' under the new CRA regulations, which were jointly promulgated by the federal financial supervisory agencies during WNB's start-up period.[19] In August 1996, the OCC designated WNB as a ''limited purpose bank'' under the new CRA regulations.[20] TDB proposes to continue to operate WNB as a limited purpose bank. The designation permits WNB's record of CRA performance to be evaluated under a separate ''community development test.''[21] Community development activities as a general matter must benefit areas within an institution's assessment area(s) or a broader statewide or regional area that includes the institution's assessment area.[22]

In anticipation of its limited purpose designation WNB refocused its CRA program, and the bank expects to incorporate the following activities into its CRA program and policies:

(1) Loan participations in programs dedicated to LMI neighborhoods;

(2) Investments in state and local housing bonds;

(3) Grants in support of programs benefiting LMI groups; and

(4) Directorships and memberships in community organizations and associations.

contains no evidence, and Protestant has supplied none, to support its allegations of discrimination or discriminatory impact in the choice of office location.

19. *See* 60 *Federal Register* 22,156 (1995). A ''limited purpose bank'' is an institution that offers only a narrow product line (like a credit card) to a regional or broader market and that has been so designated by its primary federal supervisor. 12 C.F.R. 25.11(o). The new CRA regulations permit institutions to apply for limited purpose designation after January 1, 1996, and WNB applied to the OCC in March 1996. WNB proposes to offer credit card products primarily to customers of its brokerage affiliate.

20. *See* OCC letter dated August 30, 1996, from Bert A. Otto, Acting Deputy Comptroller. Protestant disputes the OCC's determination that WNB qualifies as a limited purpose bank. Neither the CRA nor the new CRA regulations authorize the Board to review such designations by the bank's primary federal supervisor.

21. *See* 12 C.F.R. 25.21(b)(4). The test evaluates a limited purpose institution on its record of community development services, community development investments and community development lending. *See* 12 C.F.R. 25.25. The primary purpose of any service, investment or loan considered under the test must be ''community development,'' which is defined in terms of specific categories of activities that benefit LMI individuals, LMI areas, or small businesses. *See* 12 C.F.R. 25.12(h).

22. Community development activities outside an institution's assessment area may also be considered if the institution has adequately addressed the needs of its assessment area. *See* 12 C.F.R. 25.25(e).

WNB initiated its new CRA strategy in August 1996 by purchasing a $2 million New York City Housing Development Corporation bond that is dedicated to financing housing for LMI individuals. In addition, WNB has committed to make $1 million in qualified community development loans in the coming year. The bank has committed $600,000 to the Community Preservation Corporation, a private nonprofit mortgage lender specializing in financing housing for LMI families. WNB also made a $100,000 loan commitment to the Leviticus 25:23 Alternative Fund, Inc., a nonprofit community development loan fund that provides low-interest financing to organizations whose projects benefit LMI individuals and groups.

WNB provided $75,000 in grants to various organizations in support of their community development efforts, including a grant of $30,000 to the YMCA of Central and Northern Westchester. WNB also donated $4,000 to the Westchester Housing Fund to underwrite the costs of a research study on housing in the county. Additionally, members of WNB's board of directors and CRA committee serve as members of organizations dedicated to community development.

The Board has also carefully considered the effect of the proposed acquisition of WNB by TDB on the future performance of WNB under the CRA. TDB is a large banking organization with a satisfactory record of complying with United States banking regulations and substantial financial and managerial resources that are sufficient to ensure compliance by WNB with all relevant regulatory requirements. In connection with the proposal, TDB has made a number of commitments to ensure that WNB performs satisfactorily or better under the CRA. For example, TDB has provided goals for WNB's community development program and procedures for overseeing WNB's CRA program.[23] TDB also intends to work closely with the OCC and the communities involved, and to make adjustments in the bank's CRA program, including quarterly adjustments to its funding for the CRA program, as appropriate. TDB's

23. TDB has committed to support the efforts of WNB's full-time CRA officer, its CRA committee, and its board of directors. TDB also has committed to:

(1) Appoint a TDB officer who resides in New York to serve on WNB's CRA committee;

(2) Provide CRA training to TDB's compliance, legal, internal audit, and public affairs departments within three months of the acquisition of WNB;

(3) Conduct periodic unannounced on-site reviews of WNB's CRA program, the results of which will be reported to TDB's board of directors;

(4) Require monthly reports that measure past performance and detail future plans from WNB's CRA officer;

(5) Require WNB's CRA committee to file quarterly CRA reports with the WNB and Waterhouse boards of directors, and annual CRA reports with the TDB board of directors;

(6) Require that each potential CRA investment is reviewed by WNB's CRA officer, WNB's counsel, and TDB to ensure that the investment is qualified under CRA regulations; and

(7) Have the TDB and Waterhouse boards of directors review the OCC's CRA evaluations of WNB.

Protestant maintains that TDB's proposals are inadequate and that TDB's commitments are too general to be accorded any weight.

record of operating in the United States and its dealings with federal banking supervisors indicate that TDB may be relied on to implement fully the programs and policies it has committed to implement.

C. Conclusion on the Convenience and Needs Factor

The Board has carefully considered the entire record in its review of the convenience and needs factor under section 3 of the BHC Act, including information provided by the Protestant and TDB. Based on all the facts of record and for the reasons discussed above, the Board concludes that, on balance, considerations relating to the convenience and needs factor, including the CRA performance record of WNB, are consistent with approval of the proposal. To enable the Board to monitor the efforts of WNB and TDB, TDB must submit a copy of WNB's internal quarterly CRA reports to the Federal Reserve Bank of New York for two years or until WNB receives a ''satisfactory'' or better CRA rating from its primary regulator, whichever period is shorter. The Board also intends to review WNB's progress in future applications by TDB to establish a depository facility, as required by the CRA.

Nonbanking Activities

TDB also has filed notices, pursuant to section 4(c)(8) of the BHC Act, to acquire the nonbanking subsidiaries of Waterhouse and thereby engage in providing discount brokerage and related services.[24] The Board has determined that all the activities are closely related to banking,[25] and TDB has committed to conduct the nonbanking activities in accordance with Regulation Y.

In order to approve the proposal under section 4(c)(8) of the BHC Act, the Board also must determine that the proposed activities are a proper incident to banking, that is, that the proposal ''can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.'' As part of its evaluation of these factors, the Board considers the financial condition and managerial resources of the notificant and its subsidiaries, including the companies to be acquired, and the effect of the proposed transaction on those resources.[26] As noted above, based on all the facts of record, the Board has concluded that financial and managerial considerations are consistent with approval of these notices.

The Board also has carefully considered the competitive effects of the proposed acquisition of the nonbanking companies and, in so doing, has considered the comments submitted by Protestant regarding the competitive impact of the proposed acquisition.[27] The Board notes that the market for discount brokerage and related services is unconcentrated and that there are numerous providers of the services.[28] As a result, consummation of this proposal would have a *de minimis* effect on competition for brokerage services, and the Board has concluded that the proposal would not have a significant adverse effect on competition in any relevant market.

In addition, TDB expects that the proposed transaction would result in public benefits by permitting Waterhouse and its customers to draw on the greater capital resources, technological capabilities, and retail banking experience of TDB and its affiliates. For example, TDB notes that access to its extensive operations and communications systems would give Waterhouse the ability to improve productivity, to reduce costs, and thereby to reduce prices on brokerage and other services. Similarly, TDB expects that access to its financial resources should provide Waterhouse with additional working capital to expand operations to meet customer needs.[29] In sum, Waterhouse's affiliation of TDB and its subsidiaries may be expected to yield greater convenience for Waterhouse's customers and to foster improved methods of meeting the needs of those customers.[30]

For the reasons discussed above, the Board believes that the potential for adverse effects, if any, resulting from the transaction is negligible. The Board also concludes that, based on the considerations discussed above, the proposal can be expected to produce notable public benefits. Accordingly, based on all the facts of record, the Board has

24. Such services include providing securities execution, clearing, and other services incidental to securities brokerage. TDB has committed to conduct these activities according to the conditions that the Board previously has relied on in approving such activities.

25. *See* 12 C.F.R. 225.25(b)(15)(i).

26. *See* 12 C.F.R. 225.24; *see also The Fuji Bank, Limited,* 75 *Federal Reserve Bulletin* 94 (1989); *Bayerische Vereinsbank AG,* 73 *Federal Reserve Bulletin* 155 (1987).

27. Protestant contends that the affiliation of Waterhouse's discount brokerage subsidiary, WSI, with TDB's discount brokerage subsidiary, Green Line Investor Services (USA), Inc. (''Green Line''), would eliminate a current and potentially significant future competitor of WSI.

28. *See, e.g., Banc One Corporation,* 82 *Federal Reserve Bulletin* 88 (1996).

29. Protestant disputes TDB's expectations of public benefits. For example, Protestant contends that Green Line's recent expansion into Hong Kong will divert TDB's resources from WSI, and that TDB's derivatives activities raise further questions about TDB's ability to provide WSI with added financial strength. TDB is a large, diversified banking institution with significant financial resources. Based on all the facts of record, including supervisory information from Canadian banking authorities, the Board concludes that Protestant's contentions are not supported by the weight of the evidence in the record.

30. Protestant notes that TDB entered into a consent judgment with the SEC in September 1989, that prohibited TDB from engaging in securities clearing activities in the United States. TDB informed the SEC of its pending notices with the Board to acquire Waterhouse, and the SEC consented to TDB's request to remove the prohibition. Consequently, by stipulation and order dated August 2, 1996, the U.S. District Court for the Southern District of New York concluded that prohibiting TDB from engaging in the securities clearance business was ''no longer necessary to protect the public interest.'' *SEC v. Hansen,* 82 Civ. 5242 (S.D.N.Y. Aug. 2, 1996).

determined that the balance of public benefits is favorable under the proper incident to banking standard of section 4(c)(8) of the BHC Act.

Conclusion

Based on the foregoing, and in light of all the facts of record, the Board has determined that the application and notices should be, and hereby are, approved.[31] Should any restrictions on access to information on the operations or activities of TDB and its affiliates subsequently interfere with the Board's ability to obtain information to determine and enforce compliance by TDB or its affiliates with applicable federal statutes, the Board may require termination of any of TDB's direct or indirect activities in the United States. Approval of this application and notice is specifically conditioned on compliance by TDB with all the commitments made in connection with this proposal and with the conditions stated or referred to in this order.

The Board's determination on the nonbanking activities also is subject to all the terms and conditions set forth in Regulation Y, including those in sections 225.7 and 225.23(b) (12 C.F.R. 225.7 and 225.23(b)), and to the Board's authority to require such modification or termination of the activities of a bank holding company or any of its subsidiaries as the Board finds necessary to ensure compliance with, and to prevent evasion of, the provisions of the BHC Act and the Board's regulations and orders thereunder. For purposes of this transaction, the commitments and conditions referred to above shall be deemed to be conditions imposed in writing by the Board in connection with its findings and decision, and, as such, may be enforced in proceedings under applicable law.

The acquisition of WNB shall not be consummated before the fifteenth calendar day following the effective date of this order, and this proposal shall not be consummated later than three months after the effective date of this order, unless such period is extended for good cause by the Board or by the Federal Reserve Bank of New York acting pursuant to delegated authority.

By order of the Board of Governors, effective September 30, 1996.

Voting for this action: Chairman Greenspan, Vice Chair Rivlin, and Governors Kelley, Lindsey, Phillips, Yellen, and Meyer.

JENNIFER J. JOHNSON
Deputy Secretary of the Board

31. Protestant has requested that the Board hold a public hearing or meeting on the convenience and needs, managerial, adverse competitive, public benefits, and other effects resulting from this proposal. Section 3(b) of the BHC Act does not require the Board to hold a public meeting or hearing on an application unless the appropriate supervisory authority for the bank to be acquired makes a timely written recommendation of denial of the application. No supervisory agency has recommended denial in this case. Under the Board's Regulation Y, a hearing is required under section 4 of the BHC Act only if there are disputed issues of material fact that cannot be resolved in some other manner. 12 C.F.R. 225.23(f). In addition, under the Board's Rules of Procedure, the Board, in its discretion, hold a public hearing or meeting on an application to clarify factual issues relating to the application and to provide an opportunity for testimony, if appropriate. 12 C.F.R. 262.3(e) and 262.25(d).

Protestant does not identify disputed issues of fact that are material to the Board's decision, including any disputed issues of fact on the public benefits or the competitive effect of the proposal. In addition, interested parties have had an ample opportunity to present their views, and Protestant has submitted substantial written comments that have been carefully considered by the Board. Protestant's request fails to demonstrate why a written presentation would not suffice and to summarize evidence that would be presented at a hearing or meeting. *See* 12 C.F.R. 262.3(e). The Board has carefully considered the proposal in light of all the facts of record, including Protestant's comments on the issues discussed above, and, for the reasons discussed in this order, has concluded that the factors that the Board must consider under sections 3 and 4 of the BHC Act are consistent with approval. Protestant's request disputes the weight that should be accorded to, and the conclusions that the Board should draw from, the existing facts of record. For these reasons, and based on all the facts of record, the Board has determined that a public hearing or meeting is not required or warranted to clarify the factual record in the proposal, or otherwise warranted in this case. Accordingly, the request for a hearing or public meeting on the proposal is hereby denied.

Protestant also has requested that it be permitted to present its views orally to the Board. *See* 12 C.F.R. 262.3(e). For the reasons discussed above, the request for oral presentation is hereby denied.

ORDERS ISSUED UNDER INTERNATIONAL BANKING ACT

China Construction Bank
Beijing, People's Republic of China

Order Approving Establishment of a Representative Office

China Construction Bank, Beijing, People's Republic of China (''Bank''), a foreign bank within the meaning of the International Banking Act (''IBA''), has applied under section 10(a) of the IBA (12 U.S.C. § 3107(a)) to establish a representative office in New York, New York. The Foreign Bank Supervision Enhancement Act of 1991, which amended the IBA, provides that a foreign bank must obtain the approval of the Board to establish a representative office in the United States.

Notice of the application, affording interested persons an opportunity to comment, has been published in a newspaper of general circulation in New York (*The New York Times*, June 19, 1996). The time for filing comments has expired, and the Board has considered the application and all comments received.

As of March 31, 1996, Bank had total assets of approximately $211 billion. Bank, formerly known as the People's Construction Bank of China, is the third largest of four specialized banks in the People's Republic of China, and is wholly owned by the Chinese government. Bank operates more than 13,000 branches and subbranches and more than 28,000 deposit-taking offices in China, as well as three domestic financial subsidiaries.[1] Outside China, Bank operates a branch in Hong Kong and representative offices in London, England; Frankfurt, Germany; Seoul, Korea; Tokyo, Japan; and Singapore; and has a minority investment in a Hong Kong bank.

Prior to 1994, one of Bank's primary activities was fiscal lending, which constituted receiving funds from Chinese governmental bodies and state-owned enterprises and lending such funds to state-owned enterprises and infrastructure projects. In 1994, Bank became a state-owned commercial bank engaged primarily in commercial banking. Bank's activities now include commercial and retail deposit-taking, lending for its own account, and borrowing in domestic and international markets. Bank also makes disbursements for and otherwise administers loans for other government-owned banks.

In acting on an application to establish a representative office, the IBA and Regulation K provide that the Board shall take into account whether the foreign bank engages directly in the business of banking outside of the United States, has furnished to the Board the information it needs to assess the application adequately, is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor, and has provided adequate assurances of access to information on the operations of the bank and its affiliates to determine compliance with U.S. laws. (12 U.S.C. § 3107(a); 12 C.F.R. 211.24(d)). The Board also may take into account additional standards as set forth in the IBA (12 U.S.C. § 3105(d)(3)-(4)) and Regulation K (12 C.F.R. 211.24(c)). The Board previously has stated that the standards that apply to the establishment of a branch or agency need not in every case apply to the establishment of a representative office.[2] Moreover, the Board also has determined that an application by a foreign bank to establish a representative office may be approved if:

> (i) The bank commits that the proposed representative office will engage only in a limited set of activities considered to pose minimal risk to U.S. markets or U.S. counterparties; and
> (ii) The bank is subject to a supervisory framework that is consistent with approval of the application, taking into account the limited activities of the proposed office and the operating record of the bank.[3]

The activities of Bank's representative office would be limited to general marketing or promotional activities, developing and strengthening correspondent banking relationships, research and consulting activities, and certain loan solicitation activities. The representative office would not engage in activities such as making credit decisions on behalf of Bank, soliciting deposits from other than institutional investors, soliciting business of any kind from individuals acting in their personal capacity, or conducting any activities relating to trading.

The Board has considered the following information with respect to home country supervision of Bank. The People's Bank of China (the ''PBOC'') is the licensing, regulatory and supervisory authority for banks and all other financial institutions in China and, as such, is the home country supervisor of Bank. While regulation of the specialized banks by the PBOC historically has focused on the banks' compliance with state economic and financial goals, in the last several years China and its banking authorities have taken steps to develop a more market-oriented bank supervisory program placing greater emphasis on prudential standards. The PBOC establishes capital, liquidity and asset quality requirements, regulates the investments of banks in other companies, establishes internal auditing standards for Chinese banks, and monitors Chinese banks for adherence to Chinese laws and regulations. The PBOC, which has authorized Bank to establish the proposed representative office, supervises the foreign and domestic activities of Bank.

The PBOC monitors the operations of Bank through on-site examinations and the review of periodic reports from Bank. The PBOC conducts both comprehensive and limited ad hoc on-site examinations of Bank. On-site examinations generally focus on Bank's execution of economic and financial policies and compliance with financial regulations, as well as Bank's internal controls, asset quality, capital, liquidity and profitability. Bank is required to submit various periodic financial and regulatory reports to the PBOC, including balance sheets, income statements, analyses of classified loans and external debt, reports on foreign exchange risk, reports on deposits, borrowings, guarantees, and securities and investments. Bank also is required to publish its financial statements and audit report yearly.

Bank's internal audit department conducts monthly, quarterly, and annual internal audits of Bank, as well as occasional special audits. Internal audits generally review Bank's internal guidelines, operating and financial plans, budgets, and financial statements, as well as compliance with governmental and Bank's own policies. The PBOC receives copies of Bank's annual audit plan, annual work summary, and other material relating to internal audits. The proposed representative office would provide an annual operations plan and monthly reports to Bank's head office, and would receive occasional on-site inspections from the PBOC and various departments of Bank.

Based on all the facts of record, the Board concludes that factors relating to the supervision of Bank by its home country supervisor are consistent with approval of the proposed representative office. The Board also has determined that, for purposes of the IBA and Regulation K, Bank engages directly in the business of banking outside of the United States through its operations in China. Bank has provided the Board with the information necessary to as-

1. These subsidiaries are China Investment Bank, a commercial bank; The Trust and Investment Company of People's Construction Bank of China; and China Investment Consulting Corporation of China Construction Bank, a financial consulting firm.

2. *Citizens National Bank,* 79 *Federal Reserve Bulletin* 805 (1993).

3. *Promstroybank of Russia,* 82 *Federal Reserve Bulletin* 599 (1996).

sess the application through submissions that address relevant issues.

The Board also has taken into account the additional standards set forth in section 7 of the IBA and Regulation K (*see* 12 U.S.C. § 3105(d)(3),(4); 12 C.F.R. 211.24(c)(2)). As noted above, the PBOC has authorized Bank to establish the proposed representative office.

The Board also has determined that the financial and managerial factors are consistent with approval of the representative office. Bank's managerial and financial resources indicate that there is a reasonable degree of certainty concerning the financial stability of Bank, based on its operating record and financial standing within the country. In addition, Bank's operating record indicates that it is capable of complying with applicable laws.

Finally, with respect to access to information on Bank's operations, the Board has reviewed the relevant provisions of law in China and has communicated with appropriate government authorities regarding access to information. Bank has committed to make available to the Board such information on the operations of Bank and any of its affiliates that the Board deems necessary to determine and enforce compliance with the IBA, the Bank Holding Company Act of 1956, as amended, and other applicable Federal law. To the extent that the provision of such information to the Board may be prohibited or impeded by law, Bank has committed to cooperate with the Board to obtain any necessary consents or waivers that might be required from third parties in connection with disclosure of certain information. In addition, subject to certain conditions, the PBOC may share information on Bank's operations with other supervisors, including the Board. In light of the commitments provided by Bank and other facts of record, and subject to the condition described below, the Board concludes that Bank has provided adequate assurances of access to any necessary information the Board may request.

On the basis of all the facts of record, and subject to the commitments made by Bank, as well as the terms and conditions set forth in this order, the Board has determined that Bank's application to establish a representative office should be, and hereby is, approved. Should any restrictions on access to information on the operations or activities of Bank and any of its affiliates subsequently interfere with the Board's ability to determine the compliance by Bank or its affiliates with applicable federal statutes, the Board may require termination of any of Bank's direct or indirect activities in the United States. Approval of this application is also specifically conditioned on compliance by Bank with the commitments made in connection with this application and with the conditions in this order.[4] The commitments and conditions referred to above are conditions imposed in writing by the Board in connection with its decision, and may be enforced in proceedings under 12 U.S.C. § 1818 against Bank and its affiliates.

By order of the Board of Governors, effective September 23, 1996.

Voting for this action: Chairman Greenspan, Vice Chair Rivlin, and Governors Kelley, Lindsey, Phillips, and Yellen. Absent and not voting: Governor Meyer.

JENNIFER J. JOHNSON
Deputy Secretary of the Board

4. The Board's authority to approve the establishment of the proposed representative office parallels the continuing authority of the State of New York to license offices of a foreign bank. The Board's approval of this application does not supplant the authority of the State of New York and its agent, the New York State Banking Department, to license the proposed representative office of Bank in accordance with any terms or conditions that the New York State Banking Department may impose.

Applications Approved Under Bank Holding Company Act
By the Secretary of the Board

Recent applications have been approved by the Secretary of the Board as listed below. Copies are available upon request to the Freedom of Information Office, Office of the Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

Section 4

Applicant(s)	Bank(s)	Effective Date
BankAmerica Corporation, San Francisco, California Security Pacific Leasing Corporation, San Francisco, California	DFO Holding Company, Inc., San Francisco, California Ford Motor Credit Corporation, Dearborn, Michigan	September 16, 1996

By Federal Reserve Banks

Recent applications have been approved by the Federal Reserve Banks as listed below. Copies are available upon request to the Reserve Banks.

Section 3

Applicant(s)	Bank(s)	Reserve Bank	Effective Date
Ameribanc, Inc., St. Louis, Missouri	First Financial Corporation of America, Salem, Missouri	St. Louis	September 17, 1996
BanPonce Corporation, Hato Rey, Puerto Rico Popular International Bank, Inc., Hato Rey, Puerto Rico BanPonce Financial Corp., Wilmington, Delaware	COMBANCORP, City of Commerce, California Commerce National Bank, City of Commerce, California	New York	August 26, 1996
Brickyard Bancorp, Inc., Chicago, Illinois	Sysco Financial, Inc., Lincolnwood, Illinois Brickyard Bank, Lincolnwood, Illinois	Chicago	September 25, 1996
Canton Financial Corporation, Canton, Texas	The First National Bank of Canton, Canton, Texas	Dallas	August 29, 1996
Capitol Bancorp, Limited, Lansing, Michigan	Macomb Community Bank, Clinton Township, Michigan	Chicago	September 3, 1996
Castle Creek Capital Partners Fund-I, L.P., Chicago, Illinois Castle Creek Capital, L.L.C., Chicago, Illinois Eggemeyer Advisory Corp., Chicago, Illinois	Monarch Bancorp, Laguna Niguel, California	San Francisco	September 6, 1996
CB Holding Co., Edmond, Oklahoma	P.N.B. Financial Corporation, Kingfisher, Oklahoma City National Bancshares of Weatherford, Inc., Weatherford, Oklahoma	Kansas City	September 26, 1996
Centura Banks, Inc., Rocky Mount, North Carolina	FirstSouth Bank, Burlington, North Carolina	Richmond	August 30, 1996
Chester Bancorp, Inc., Chester, Illinois	Chester National Bank, Chester, Illinois Chester National Bank of Missouri, Perryville, Missouri	St. Louis	September 12, 1996
Community Central Bank Corporation, Mount Clemens, Michigan	Community Central Bank, Mount Clemens, Michigan	Chicago	September 11, 1996
Crestmark Bancorp, Inc., Bloomfield Hills, Michigan	Crestmark Bank, Troy, Michigan Crestmark Financial, Inc., Troy, Michigan	Chicago	August 22, 1996
F&M Bancorp, Frederick, Maryland	Home Federal Corporation, Hagerstown, Maryland	Richmond	August 23, 1996
First American Bank Corporation, Elk Grove Village, Illinois	Oak Park River Forest Bankshares, Inc., Oak Park, Illinois	Chicago	September 23, 1996

Section 3—Continued

Applicant(s)	Bank(s)	Reserve Bank	Effective Date
FirstValue Corporation, Appleton, Wisconsin	Tigerton Bancorporation, Tigerton, Wisconsin First National Bank in Tigerton, Tigerton, Wisconsin	Chicago	September 11, 1996
Henderson Citizens Bancshares, Inc., Henderson, Texas Henderson Citizens Bancshares of Delaware, Inc., Dover, Delaware	Waskom Bancshares, Inc., Waskom, Texas First State Bank, Waskom, Texas	Dallas	August 26, 1996
Ida Grove Bancshares, Inc., Ida Grove, Iowa American Bancshares, Inc., Holstein, Iowa	Farmers State Bank, Charter Oak, Iowa	Chicago	September 18, 1996
Key Capital Corporation, Inc., Owings Mills, Maryland	Key Bank and Trust, Randallstown, Maryland	Richmond	September 13, 1996
Lakes Region Bancorp, Inc., Bannockburn, Illinois	Anchor Bank, Third Lake, Illinois	Chicago	September 19, 1996
LandMark Bancshares of Texas, Inc., Columbia, Missouri	Itasca State Bank, Itasca, Texas	St. Louis	September 9, 1996
The Landrum Company, Columbia, Missouri	LandMark Bancshares of Texas, Inc., Columbia, Missouri	St. Louis	September 9, 1996
Lewis Family Partners, L.P., Morris, Illinois Lewis Management Company, Morris, Illinois	Illinois Valley Bancorp, Inc., Morris, Illinois Grundy County National Bank, Morris, Illinois	Chicago	September 6, 1996
Mercantile Bancorporation Inc., St. Louis, Missouri	First Financial Corporation of America, Salem, Missouri	St. Louis	September 17, 1996
Mercantile Bancorporation Inc., St. Louis, Missouri	Today's Bancorp, Inc., Freeport, Illinois Today's Bank-East, Freeport, Illinois Today's Bank-West, Galena, Illinois	St. Louis	September 17, 1996
Mercantile Bancorporation Incorporated of Illinois, St. Louis, Missouri	Today's Bancorp, Inc., Freeport, Illinois	St. Louis	September 17, 1996
Merchants Bancorp, Inc., Hillsboro, Ohio	Merchants National Bank, Hillsboro, Ohio	Cleveland	September 12, 1996
Mid-Peninsula Bancorp, Palo Alto, California	Cupertino National Bancorp, Cupertino, California Cupertino National Bank & Trust, Cupertino, California	San Francisco	September 25, 1996
Monarch Bancorp, Laguna Niguel, California	Western Bank, Los Angeles, California	San Francisco	September 6, 1996
National Bancshares Corporation of Texas, Laredo, Texas NBT of Delaware, Inc., Wilmington, Delaware	Luling Bancshares, Inc., Luling, Texas First National Bank, Luling, Texas	Dallas	September 6, 1996

Section 3—Continued

Applicant(s)	Bank(s)	Reserve Bank	Effective Date
Norma McLane-Smith Family Limited Partnership, Poplar Bluff, Missouri	Poplar Bluff Banc Company, Poplar Bluff, Missouri Midwest Bancshares, Inc., Poplar Bluff, Missouri	St. Louis	September 17, 1996
Norwest Corporation, Minneapolis, Minnesota	American Bank Moorhead, Moorhead, Minnesota	Minneapolis	August 30, 1996
Oak Park River Forest Bankshares, Inc., Oak Park, Illinois	Community Bank of Oak Park River Forest, Oak Park, Illinois	Chicago	September 20, 1996
Omni Bancshares, Inc., Metairie, Louisiana	Omni Bank, Metairie, Louisiana	Atlanta	August 28, 1996
PCB Bancorp, Inc., Johnson City, Tennessee	People's Community Bank, Johnson City, Tennessee	Atlanta	August 26, 1996
Regions Financial Corporation, Birmingham, Alabama	American Bancshares of Houma, Inc., Houma, Louisiana American Bank & Trust Company of Houma, Houma, Louisiana	Atlanta	August 28, 1996
San Angelo Bancorp, Inc., Dover, Delaware	Texas State Bank, San Angelo, Texas	Dallas	September 13, 1996
South Alabama Bancorporation, Inc., Mobile, Alabama	First Monco Bancshares, Inc., Monroeville, Alabama The Monroe County Bank, Monroeville, Alabama	Atlanta	August 22, 1996
Southwest Missouri Bancshares, Inc., Ozark, Missouri	Southwest Community Bank, Ozark, Missouri	St. Louis	August 27, 1996
St. Joseph Capital Corporation, South Bend, Indiana	St. Joseph Capital Bank, Mishawaka, Indiana	Chicago	September 4, 1996
Texas Bancorp, Inc., San Angelo, Texas	San Angelo Bancorp, Inc., Dover, Delaware Texas State Bank, San Angelo, Texas	Dallas	September 13, 1996
Texas Financial Bancorporation, Inc., Minneapolis, Minnesota	The Farmers and Mechanics Bank, Galesburg, Illinois	Dallas	September 19, 1996
ValliCorp Holdings, Inc., Fresno, California	Auburn Bancorp, Auburn, California	San Francisco	August 21, 1996
WesBanco, Inc., Wheeling, West Virginia	Vandalia National Corporation, Morgantown, West Virginia	Cleveland	September 20, 1996
Western Acquisition Partners, L.P., Buffalo Grove, Illinois	Western Acquisitions, L.L.C., Buffalo Grove, Illinois Sunwest Bank, Tustin, California	San Francisco	August 22, 1996

Section 4

Applicant(s)	Nonbanking Activity/Company	Reserve Bank	Effective Date
Allegiant Bancorp, Inc., St. Louis, Missouri	Edge Mortgage Services, Inc., Maryland Heights, Missouri	St. Louis	September 13, 1996
Bayerische Vereinsbank AG, Munich, Germany	VB Structured Finance Inc., New York, New York	New York	September 12, 1996
Capitol Bankshares, Inc., Madison, Wisconsin	Capitol Mortgage Corporation, Madison, Wisconsin	Chicago	August 30, 1996
Centennial Holdings. Ltd, Olympia, Washington	Totten, Inc., Olympia, Washington	San Francisco	September 17, 1996
Citizens Development Company, Billings, Montana	To engage *de novo* in data processing activities	Minneapolis	September 24, 1996
Dadeland Bancshares, Inc., Miami, Florida	Dadeland Software Services, Inc., Miami, Florida	Atlanta	September 13, 1996
Decatur Financial Inc., Decatur, Indiana	Independent Bankers Life Insurance Company of Indiana, Phoenix, Arizona	Chicago	September 5, 1996
First Alliance Bancorp, Inc., Marietta, Georgia	Premier Bancshares, Inc., Atlanta, Georgia Premier Bank, F.S.B., Atlanta, Georgia Premier Lending Corporation, Atlanta, Georgia	Atlanta	August 22, 1996
First Commercial Corporation, Little Rock, Arkansas	To engage *de novo* in the leasing of personal property	St. Louis	September 11, 1996
First Interstate BancSystem of Montana, Inc., Billings, Montana JS Investments, Limited Partnership, Billings, Montana Nbar5, Limited Partnership, Ranchester, Wyoming	First Interstate Bank of Commerce, fsb, Hamilton, Montana	Minneapolis	September 4, 1996
Fulton Financial Corporation, Lancaster, Pennsylvania	To engage in community development activities	Philadelphia	September 20, 1996
Imperial Bancorp, Los Angeles, California	Pacific Bancard Association, Inglewood, California American Heritage/Pacific Bancard Association, Chatsworth, California	San Francisco	August 26, 1996
I.S.B. Financial Corp., Oak Forest, Illinois	To engage *de novo* in making and servicing loans	Chicago	September 24, 1996
Mercantile Bancorporation Inc., St. Louis, Missouri	Today's Insurance Source Agency, Inc., East Dubuque, Illinois	St. Louis	September 17, 1996
Mountain Bancshares, Inc., Yellville, Arkansas	The Bank of Yellville Financial Services, Yellville, Arkansas	St. Louis	September 24, 1996
Otto Bremer Foundation, St. Paul, Minnesota Bremer Financial Corporation, St. Paul, Minnesota	CFS Financial Corp., Minnestonka, Minnesota	Minneapolis	August 23, 1996

Section 4—Continued

Applicant(s)	Nonbanking Activity/Company	Reserve Bank	Effective Date
Pinnacle Banc Group, Inc., Oakbrook, Illinois	Financial Security Corp., Chicago, Illinois Security Federal Savings and Loan Association, Chicago, Illinois Dovenmuehle Mortgage Company, L.P., Schaumburg, Illinois	Chicago	August 30, 1996
Quad City Holdings, Inc., Bettendorf, Iowa	Nobel Electronic Transfer, L.L.C., Bettendorf, Iowa	Chicago	September 3, 1996
St. Clair Agency, Inc., St. Clair, Minnesota	Clarice Germo Agency, St. Clair, Minnesota	Minneapolis	September 5, 1996
Stichting Prioriteit ABN AMRO Holding, Amsterdam, The Netherlands Stichting Administratiekantoor ABN AMRO Holding, Amsterdam, The Netherlands ABN AMRO Holding N.V., Amsterdam, The Netherlands ABN AMRO Bank N.V., Amsterdam, The Netherlands ABN AMRO North America, Inc., Chicago, Illinois	Heigl Mortgage and Financial Corporation, Bloomington, Minnesota	Chicago	September 26, 1996

Sections 3 and 4

Applicant(s)	Nonbanking Activity/Company	Reserve Bank	Effective Date
Collective Bancorp, Inc., Egg Harbor, New Jersey	Continental Bancorporation, Laurel Springs, New Jersey	Philadelphia	August 30, 1996
First Midwest Financial, Inc., Storm Lake, Iowa	Central West Bancorporation, Casey, Iowa Security State Bank, Stuart, Iowa	Chicago	August 28, 1996

APPLICATIONS APPROVED UNDER BANK MERGER ACT
By Federal Reserve Banks

Recent applications have been approved by the Federal Reserve Banks as listed below. Copies are available upon request to the Reserve Banks.

Applicant(s)	Bank(s)	Reserve Bank	Effective Date
Centura Bank, Rocky Mount, North Carolina	FirstSouth Bank, Burlington, North Carolina	Richmond	August 30, 1996
Crestar Bank MD, Bethesda, Maryland	Crestar Bank FSB, Baltimore, Maryland	Richmond	September 25, 1996
First Banking Center - Burlington, Burlington, Wisconsin	American National Bank & Trust Company of Chicago, Chicago, Illinois	Chicago	September 5, 1996
First Community Bank, Inc., Buckhannon, West Virginia	Huntington National Bank West Virginia, Charleston, West Virginia	Richmond	September 11, 1996
The First Trust & Savings Bank, Aurelia, Iowa	Cleghorn State Bank, Cleghorn, Iowa	Chicago	September 13, 1996
Mercantile Bank of Polk County, Des Moines, Iowa	Mercantile Bank of the Bluffs, Council Bluffs, Iowa Mercantile Bank of Boone, Boone, Iowa Mercantile Bank of Centerville, Centerville, Iowa Mercantile Bank of Chariton, Chariton, Iowa Mercantile Bank of Clay County, Spencer, Iowa Mercantile Bank of Humboldt County, Humboldt, Iowa Mercantile Bank of Jasper County, Newton, Iowa Mercantile Bank of Lyon County, Rock Rapids, Iowa Mercantile Bank of Marshalltown, Marshalltown, Iowa Mercantile Bank of Mount Ayr, Mount Ayr, Iowa Mercantile Bank of Onawa, Onawa, Iowa Mercantile Bank of Osceola County, Sibley, Iowa Mercantile Bank of Pella, Pella, Iowa	Chicago	August 28, 1996
ValliWide Bank, Fresno, California	The Bank of Commerce, N.A., Auburn, California	San Francisco	August 21, 1996

Pending Cases Involving the Board of Governors

This list of pending cases does not include suits against the Federal Reserve Banks in which the Board of Governors is not named a party.

Clifford v. Board of Governors, No. 96–1342 (D.C. Cir., filed September 17, 1996). Petition for review of Board order dated August 21, 1996, denying petitioners' motion to dismiss enforcement action against them.

Artis v. Greenspan, No. 96-CV-02105 (D. D.C., filed September 11, 1996). Class complaint alleging race discrimination in employment. Awaiting service.

Leuthe v. Board of Governors, No. 96–5725 (E.D. Pa., filed August 16, 1996). Action against the Board and other Federal banking agencies challenging the constitutionality of the Office of Financial Institution Adjudication.

Long v. Board of Governors, No. 96–9526 (10th Cir., filed July 31, 1996). Petition for review of Board order dated July 2, 1996, assessing a civil money penalty and cease and desist order for violations of the Bank Holding Company Act.

Esformes v. Board of Governors, No. 96–1916 (S.D. Fla., filed July 12, 1996). Complaint challenging Board denial of administrative request for confidential supervisory information. Plaintiffs' motion for an expedited hearing was denied on August 1, 1996. On September 20, 1996, the Board filed a motion to dismiss or for summary judgment.

Board of Governors v. Interamericas Investments, Ltd., No. 96–7108 (D.C. Cir., filed June 14, 1996). Appeal of district court ruling granting, in part, the Board's application to enforce an adminstrative investigatory subpoena for documents and testimony. Appellants' motion for a stay of the district court ruling was denied on September 12, 1996.

Interamericas Investments, Ltd. v. Board of Governors, No. 96–60326 (5th Cir., filed May 8, 1996). Petition for review of order imposing civil money penalties and cease and desist order in enforcement case. Petitioners' brief was filed on July 26, 1996, and the Board's brief was filed on September 27, 1996. On August 20, petitioners' motion for a stay of the Board's orders pending judicial review was denied by the Court of Appeals.

Kuntz v. Board of Governors, No. 96–1137 (D.C. Cir., filed April 25, 1996). Petition for review of a Board order dated March 25, 1996, approving an application by CoreStates Financial Corp., Philadelphia, Pennsylvania to acquire Meridian Bancorp, Inc., Reading, Pennsylvania. The Board's motion to dismiss was filed on June 3, 1996.

Kuntz v. Board of Governors, No. 96–1079 (D.C. Cir., filed March 7, 1996). Petition for review of a Board order dated February 7, 1996, approving applications by The Fifth Third Bank, Cincinnati, Ohio, and The Firth Third Bank of Columbus, Columbus, Ohio, to acquire certain assets and assume certain liabilities of 25 branches of NBD Bank, Columbus, Ohio. Petitioner has moved to consolidate the case with *Kuntz v. Board of Governors,* No. 95–1495. On April 8, 1996, the Board filed a motion to dismiss the action.

Henderson v. Board of Governors, No. 96–1054 (D.C. Cir., filed February 16, 1996). Petition for review of a Board order dated January 17, 1996, approving the merger of First Citizens BancShares, Inc., Raleigh, North Carolina, with Allied Bank Capital, Inc., Sanford, North Carolina. Petitioners' motion for a stay was denied on March 7, 1996.

Research Triangle Institute v. Board of Governors, No. 1:96CV00102 (M.D.N.C., filed February 12, 1996). Contract dispute. On May 3, 1996, the Board filed a motion to dismiss the action.

Inner City Press/Community on the Move v. Board of Governors, No. 96–4008 (2nd Cir., filed January 19, 1996). Petition for review of a Board order dated January 5, 1996, approving the applications and notices by Chemical Banking Corporation to merge with The Chase Manhattan Corporation, both of New York, New York, and by Chemical Bank to merge with The Chase Manhattan Bank, N.A., both of New York, New York. Petitioners' motion for an emergency stay of the transaction was denied following oral argument on March 26, 1996. The Board's brief on the merits was filed July 8, 1996. The case has been consolidated for oral argument and decision with *Lee v. Board of Governors,* No. 95–4134 (2d Cir.).

Menick v. Greenspan, No. 95-CV-01916 (D. D.C., filed October 10, 1995). Complaint alleging sex, age, and handicap discrimination in employment.

Kuntz v. Board of Governors, No. 95–1495 (D.C. Cir., filed September 21, 1995). Petition for review of Board order dated August 23, 1995, approving the applications of The Fifth Third Bank, Cincinnati, Ohio, to acquire certain assets and assume certain liabilities of 12 branches of PNC Bank, Ohio, N.A., Cincinnati, Ohio, and to establish certain branches. The Board's motion to dismiss was filed on October 26, 1995.

Lee v. Board of Governors, No. 95–4134 (2nd Cir., filed August 22, 1995). Petition for review of Board orders dated July 24, 1995, approving certain steps of a corporate reorganization of U.S. Trust Corporation, New York, New York, and the acquisition of U.S. Trust by Chase Manhattan Corporation, New York, New York. On September 12, 1995, the court denied petitioners' motion for an emergency stay of the Board's orders. The Board's brief was filed on April 16, 1996.

Beckman v. Greenspan, No. 95–35473 (9th Cir., filed May 4, 1995). Appeal of dismissal of action against Board and others seeking damages for alleged violations of constitutional and common law rights. The appellants' brief was filed on June 23, 1995; the Board's brief was filed on July 12, 1995.

Money Station, Inc. v. Board of Governors, No. 95–1182 (D.C. Cir., filed March 30, 1995). Petition for review of a Board order dated March 1, 1995, approving notices by Bank One Corporation, Columbus, Ohio; CoreStates Financial Corp., Philadelphia, Pennsylvania; PNC Bank Corp., Pittsburgh, Pennsylvania; and KeyCorp, Cleveland, Ohio, to acquire certain data processing assets of National City Corporation, Cleveland, Ohio, through a joint venture subsidiary. On April 23, 1996, the court vacated the Board's order. On July 31, 1996, the full court granted the Board's suggestion for rehearing *en banc,* and vacated the April 23 panel decision.

In re Subpoena Duces Tecum, Misc. No. 95–06 (D.D.C., filed January 6, 1995). Action to enforce subpoena seeking predecisional supervisory documents sought in connection with an action by Bank of New England Corporation's trustee in bankruptcy against the Federal Deposit Insurance Corporation. The Board filed its opposition on January 20, 1995. Oral argument on the motion was held July 14, 1995.

Board of Governors v. Pharaon, No. 91-CIV-6250 (S.D. New York, filed September 17, 1991). Action to freeze assets of individual pending administrative adjudication of civil money penalty assessment by the Board. On September 17, 1991, the court issued an order temporarily restraining the transfer or disposition of the individual's assets.

Final Enforcement Decision Issued by the Board of Governors

In the Matter of

Donald E. Hedrick and John K. Snyder
Rushville National Bank
Rushville, Indiana

Docket Nos.

OCC-AA-EC-92–176
OCC-AA-EC-94–94

Final Decision

This is an administrative proceeding pursuant to section 8(e) of the Federal Deposit Insurance Act (''FDI Act''), 12 U.S.C. § 1818(e), in which the Office of the Comptroller of the Currency of the United States of America (''OCC'') seeks to prohibit Donald E. Hedrick and John K. Snyder (the ''Respondents'') from further participation in the affairs of any federally-supervised financial institution as a result of their conduct during their former affiliations with Rushville National Bank, Rushville, Indiana (the ''Bank''). As required by statute, the OCC has referred the action to the Board of Governors of the Federal Reserve System (the ''Board'') for final decision.

The proceeding comes before the Board in the form of a 186-page Recommended Decision by Administrative Law Judge (''ALJ'') Walter J. Alprin, issued following an administrative hearing held in phases between May 1993 and April 1995, and the filing of post-hearing briefs by the parties. In the Recommended Decision, the ALJ found that Respondent Hedrick had engaged in a variety of banking misconduct during his tenure as Chairman of the Board of the Bank, including causing the Bank to pay legal fees that should have been borne by the Bank's directors individually, causing the Bank to violate various restrictions on lending—in some cases through the use of nominee borrowers—and improperly financing a personally-owned interest in a real estate development with the Bank's funds. The ALJ concluded that this misconduct constituted unsafe and unsound practices, breaches of fiduciary duty, and violations of law resulting in gain to Hedrick and loss to the Bank. The ALJ found that Respondent Snyder had participated in one of Hedrick's improper transactions by agreeing to act as a nominee borrower to disguise an improper extension of credit to Hedrick, and that misconduct caused loss to the Bank and led to gain by Snyder. The ALJ further found that Hedrick's and Snyder's conduct reflected both willful and continuing disregard for the safety or soundness of the Bank as well as personal dishonesty warranting their prohibition from banking. Respondents have submitted exceptions to these findings, challenging the OCC's characterization of the facts, and in some instances, its authority to bring the action.

Based on a review of the record and the arguments raised by the Respondents, the Board rejects these exceptions for the reasons stated by the ALJ in the Recommended Decision, except as specifically noted in this Decision.[1] The chief arguments made by the Respondents with regard to each of the transactions that form the basis for the prohibition action are summarized below. As explained below, the Board finds that these arguments do not warrant a rejection of the ALJ's recommendation that Hedrick and Snyder should be prohibited from banking.

Accordingly, the Board hereby makes its Final Decision, and adopts the ALJ's Recommended Decision insofar as it relates to the prohibition action, except as specifically supplemented or modified herein. The Board therefore orders that the attached Orders of Prohibition issue against Respondents prohibiting them from future participation in the affairs of any federally-supervised financial institution without the approval of the appropriate supervisory agency.

I. Statement of the Case

A. Statutory Framework

1. Standards for Prohibition Order

Under the FDI Act, the ALJ is responsible for conducting an administrative hearing on a notice of intention to prohibit participation. 12 U.S.C. § 1818(e)(4). Following the hearing, the ALJ issues a recommended decision that is referred to the Board. The parties may then file with the Board exceptions to the ALJ's recommendations. The Board makes the final findings of fact, conclusions of law,

1. The Board does not reach, and makes no conclusions regarding, the ALJ's recommendations concerning Hedrick's alleged securities fraud. *See* Recommended Decision (''RD'') 102–121.

and determination whether to issue an order of prohibition. *Id*.; 12 C.F.R. 263.40.

The substantive basis for an FDI Act prohibition order requires that the Board must make each of three findings:

(1) there must be a specified type of **misconduct**—violation of law, unsafe or unsound practice, or breach of fiduciary duty;

(2) the misconduct must have a prescribed **effect**—financial gain to the respondent or financial loss or other damage to the institution; and

(3) the misconduct must involve **culpability** of a certain degree—personal dishonesty or willful or continuing disregard for the safety or soundness of the institution.

2. Statutory and Regulatory Lending Restrictions

A number of laws and regulations restrict banks' transactions with affiliates, insider lending, and concentrations of credit.

a. *Affiliate Transaction Limits.* Section 23A of the Federal Reserve Act restricts the volume of transactions between a bank and its affiliates, requires that extensions of credit by a bank to an affiliate meet specific collateral requirements, and requires generally that affiliate transactions be on terms and conditions that are consistent with safe and sound banking practices. 12 U.S.C. § 371c.

b. *Insider Lending Limits.* Regulation O and commensurate regulations of the OCC for national banks implement statutory restrictions on extensions of credit from banks to individuals who are bank "insiders," *i.e.*, individuals who are bank executive officers (including chairman of the board), directors, or principal shareholders, as well as with their "related interests". 12 U.S.C. §§ 375a, 375b; 12 C.F.R. parts 31, 215. These restrictions place absolute and relative limits on extensions of credit to individual insiders and to all insiders in the aggregate, and also impose reporting and approval requirements for such transactions. *See* 12 U.S.C. § 375a; 12 C.F.R. 31.2, 215.4(b)(1). An extension of credit is considered made to an insider to the extent that the proceeds are transferred to the insider or are used for the tangible economic benefit of the insider. 12 C.F.R. 215.3(f).

c. *Concentration of Credit Limits.* Another restriction addresses the risks inherent in a concentration of credit from a national bank to a single borrower. 12 U.S.C. § 84. Under this section, the total loans and other extensions of credit to any single borrower in general may not exceed fifteen percent of a national bank's unimpaired capital and surplus.

3. Indemnification Limits

An OCC regulation generally permits banks to provide in their articles of association for the indemnification of directors, officers or employees for expenses reasonably incurred in actions arising out of the performance of their official duties. 12 C.F.R. 7.5217(a). The regulation specifies, however, that such indemnification shall not be allowed for "expenses, penalties or other payments incurred in an administrative proceeding or action instituted by an appropriate bank regulatory agency which proceeding or action results in a final order assessing civil money penalties or requiring affirmative action by an individual or individuals in the form of payments to the bank." 12 C.F.R. 7.5217(b).

B. Procedural History

The OCC issued Notices of Intention to Prohibit Further Participation ("Prohibition Notices") against Respondents Hedrick and Snyder on November 12, 1992, and April 18, 1993, respectively. RD 1–2. The OCC also brought actions against Hedrick and Snyder seeking civil money penalties and actions against Hedrick and another director for affirmative relief, including restitution.[2] The final decision as to these non-prohibition actions is statutorily assigned to the Comptroller. The Board takes official notice that the Comptroller issued his Decision and Order on August 19, 1996, ordering Hedrick to pay a civil money penalty of $250,000 and restitution of $451,686, Snyder to pay a civil money penalty of $25,000, and the other director to pay restitution in the amount of $139,605.

Discussion

1. Relevant Persons and Institutions

Rushville was at all times relevant to this proceeding a national bank subject to supervision by the OCC. RD 4. It was declared insolvent and closed on December 18, 1992.

Respondent Hedrick served as chairman of the board and director of the Bank from May 21, 1985 to November 12, 1992 (RD 5). Hedrick was a 50 percent owner of the bank holding company that owned the Bank until 1989, when, through one of the transactions discussed below, he became the principal shareholder. Hedrick was also president of the Bank from June 1989 to June 1991. RD 30.

Respondent Snyder was a director of the Bank at all times relevant to the charges against him and was Vice-Chairman of the board of directors for a portion of that time. RD 5.

2. Snyder Loan

In 1988 and early 1989, Hedrick owned 50 percent of the stock in Hoosier Bancorp ("Hoosier"), the holding company that owned 87 percent of the stock of the Bank. RD 49. The other 50 percent was owned by Philip Schwab, a bank director, who pledged the shares as security for loans. In 1988 and early 1989, Schwab became involved in personal bankruptcy proceedings that tied up his Hoosier shares. RD 50. Hedrick owned an option to acquire Schwab's Hoosier shares. RD 50.

2. The OCC's charges against other individuals affiliated with the Bank were settled prior to hearing. RD 2.

There were two encumbrances on Schwab's shares. The senior lien was held by Summit Bank of Fort Wayne, Indiana, which also had possession of Schwab's stock, to secure a $375,000 loan on which Hedrick was the guarantor or co-signer. RD 50. The junior lien on the stock was held by the Bank to secure a $300,000 loan. RD 50; OCC Ex. 19. Hedrick secured release of Schwab's Hoosier shares in the bankruptcy proceeding by arguing, in part, that the Bank was experiencing regulatory criticism for nonpayment of the loan secured by the stock. OCC Ex. 21. When he acquired Schwab's Hoosier shares, Hedrick assumed the Schwab loan from Summit on which he was guarantor and began making payments on the loan to Summit. RD 52; Joint Stipulation (''Jt. Stip.'') 68. Hedrick knew that he could not personally assume the Bank's loan to Schwab because legal limits on loans to executive officers (''insider lending restrictions'') prevented him from doing so. Hedrick Tr. 1762, 2031. Instead, on December 15, 1989, the Bank originated a $300,000 loan to Snyder, then a bank director. RD 53; OCC Ex. 16. Snyder used the proceeds to pay off $300,000 of the Schwab loan. RD 53. The Bank charged off the remaining $5,042 in principal, releasing its junior lien on the stock even though the remaining $76,678 in interest remained unpaid, thereby removing an encumbrance on the shares owned by Hedrick. RD 53.[3]

The note that Snyder executed to the Bank as evidence of the loan stated that the loan was a consumer loan for the purpose of ''investment in holding company.'' The loan was secured by a coin collection, carried a 13 percent interest rate, and matured in three years. RD 53. The $300,000 loan was undersecured in that, while the Bank did not obtain an appraisal of the coins pledged as collateral, Snyder's contemporaneous financial statement showed the coins' value to be $40,000. RD 54; OCC Ex. 3. The loan terms required semi-annual interest-only payments in 1990 and semi-annual principal and interest payments beginning in 1991 and continuing until the maturity of the loan in December 1992. Snyder's contemporaneous financial statement and income tax statements showed insufficient income to make the necessary payments without selling his other assets. RD 54–55; OCC Ex. 3, 5; Lewis Tr. 1061. The board of directors approved the Snyder loan by a unanimous voice vote, with Hedrick present. RD 55; OCC Ex. 15.

At about the same time, Hedrick transferred 7,500 Hoosier shares (out of the 38,161 shares that he owned but that were in Summit's possession) to Snyder. RD 56. In his testimony, Hedrick made clear that these shares were not purchased by Snyder, but were given to him by Hedrick. Hedrick Tr. 1923.[4] Shortly thereafter, Hedrick and Snyder executed a written agreement (the ''Hedrick/Snyder Agreement'') whereby Hedrick would make periodic payments to Snyder that corresponded in time and amount to the interest and principal amounts due to the Bank on the Snyder loan. RD 57; OCC Ex. 1. The agreement also called for Snyder to transfer the 7,500 shares back to Hedrick, in amounts proportionate to each principal payment made on the Snyder loan. OCC Ex. 1. Hedrick was to make payments on the Snyder loan if Snyder were unable to make them. Hedrick Tr. 1927. Hedrick did not inform the board of directors of the nature of the Hedrick/Snyder Agreement. RD 57; OCC Ex. 15; Hanni Tr. 2180–81. In practice, Hedrick made payments on the Snyder loan directly to the Bank. RD 58.[5]

In 1991, when Hedrick could not make a payment on time, Hedrick and Snyder altered the terms of their agreement to defer the dates of payment to Snyder. RD 58; Snyder Tr. 35–36. Shortly thereafter, the Bank, with Hedrick voting, restructured the terms of Snyder's loan (the ''Restructure''), requiring only a single partial payment at maturity, with no specific plan to retire the debt. RD 59; OCC Ex. 4, 30. Later, on April 6, 1992, the Hedrick/Snyder agreement was again amended to reschedule the amounts due under the agreement, and the board of directors, with Hedrick voting, then approved a parallel extension of the date for payment to the Bank of the principal due on the Snyder loan. RD 61; OCC Ex. 33.

No further payments on the Snyder loan were made. RD 61. On December 18, 1992, when the Bank was declared insolvent and closed, the Bank charged off $260,000 in principal on the Snyder loan and reversed accrued interest of $52,081. RD 61.

Snyder's repayment of the Schwab loan with the proceeds of the Snyder loan was a device that benefitted Hedrick because it enabled him to acquire the Hoosier shares when he knew that he was legally precluded from assuming the Schwab loan encumbering those shares. RD 61. The Restructure of the Snyder loan benefitted Hedrick by easing the repayment schedule to the Bank, and nominally Hedrick's obligations to Snyder, when Hedrick was unable to make the required payments. RD 61–62.

Both the initiation and the Restructure of the Snyder loan caused the Bank to violate legal limits on loans to executive officers.[6] The loan was attributable to Hedrick for purposes of lending limits because, under the applicable regulation: ''An extension of credit is considered made

3. While there is no evidence that any affirmative action was taken to release the lien, the loan that the lien secured was repaid and no action was taken to pledge the shares to secure the Snyder loan. *Cf.* Lewis Tr. 1023–24.

4. This arrangement makes clear that the Snyder loan was not, in fact, for the purpose of investing in the holding company, as Snyder's note stated.

5. Through a related company, Hedrick made payments of $19,447 on July 6 and December 28, 1990, RD 58, and on July 24, 1991. RD 60–61. Hedrick claimed the interest payments on the Snyder loan as tax-deductible loan interest. RD 61. Snyder did not deduct the interest payments on his income tax return. RD 61.

6. Loans and other extensions of credit attributable to Hedrick after the Snyder loan was made totaled about $358,383, causing the Bank to exceed the individual insider lending limit by approximately $275,983. RD 62; OCC Ex. 35. Loans and other extensions of credit attributable to Hedrick after the Restructure totaled about $391,520, which exceeded the individual insider lending limit by about $342,770 and exceeded the Bank's aggregate insider lending limit by $99,020. RD 63; OCC Ex. 38.

to an insider to the extent that the proceeds are transferred to the insider or are used for the tangible economic benefit of the insider.'' 12 C.F.R. 215.3(f). Here, Hedrick not only received the tangible benefits of the extension of credit through the payment of the amount due on the Schwab loan and the release of the junior lien on the stock he owned, but he functioned as the borrower in all but name. Snyder received no direct benefit from the loan, since the proceeds were immediately devoted to retiring the Schwab loan for Hedrick's benefit, the 7,500 shares of stock were to be returned to Hedrick as he paid down the loan, and the shares were worth less than the $300,000 liability he undertook. Snyder testified that he did not expect to make payments on the loan (Snyder Tr. 31), testimony supported by his financial position and by the fact that Hedrick in fact made payments on the loan directly. RD 79–80. The loan's terms were modified when Hedrick, not Snyder, had difficulty making the payments. Hedrick, but not Snyder, deducted the interest on his income taxes. Accordingly, it is clear that the loan was made for Hedrick's benefit and is properly attributable to him for purposes of insider lending restrictions. It is also clear that Snyder's involvement was that of a nominee to disguise the economic and legal realities of the loan to Hedrick.

The ALJ found that Hedrick repaid Snyder for his participation in the Snyder Loan by appointing him Vice-Chairman of the board of directors two months after the loan was made, a position that carried with it some additional income and health insurance. RD 81. The ALJ noted that Snyder had preexisting health problems and could not obtain other coverage, so that employer-paid health insurance was a very valuable benefit. RD 82.

In their exceptions, Respondents essentially argue that the Snyder loan was not an extension of credit to Hedrick but rather the benign assumption of a nonperforming loan by a qualified investor for the benefit of the Bank. Exceptions 18–24. Respondents argue that Snyder incurred the indebtedness to protect the Bank from a loss on the Schwab loan and that Hedrick received no benefit from the loan. Resp. Exceptions 17–24. Respondents also argue that the nominee arrangement was not deceptive because bank personnel and OCC examiners were aware of the arrangement.

The Board adopts the ALJ's rejection of these arguments. First, there is no contemporaneous evidence that the extension of credit was for the purpose of protecting the Bank, since it was labelled a consumer loan for investment in a holding company. RD 77. Furthermore, the economic realities of the loan undercut the argument, since Snyder did not have the liquid assets to make the payments due on the loan and showed no disposition to liquidate his other assets to make the payments. Instead, the Bank in substance had to look to Hedrick for repayment of the loan. This not only violated various restrictions on insider lending, but was ultimately futile, since Hedrick was able to manipulate the terms of his repayment and caused the Bank to suffer a loss of $260,000 in principal and $52,000 in accrued interest on the Snyder Loan. Furthermore, the nominee nature of the loan, which was inherently deceptive, refutes the suggestion that the loan was legitimately believed to be entirely for the benefit of the Bank. RD 78.

The peculiar characteristics of the Hedrick/Snyder Agreement also rebut the argument that the arrangement was generally known and endorsed by Bank and OCC personnel. As an OCC examiner testified, he heard of the ''buy-sell'' agreement between Hedrick and Snyder, and understood it to give Hedrick an option on Snyder's Hoosier stock, so that the stock would not ''fall in unfriendly hands.'' Holland Tr. 2244–45. Accordingly, knowledge of the existence of the Snyder loan and the Hedrick/Snyder Agreement, since it was consistent with the assumption that Snyder was the substantive borrower on the loan and that he had merely given Hedrick a right of first refusal on the stock securing the loan, does not negate the deceptive purpose and effect of the arrangement.

The lending limit violations caused by the Snyder loan were exacerbated by further extensions of credit to Hedrick that expanded the scope of his violations. On March 26, 1991, the Bank made a $50,000 loan to Hedrick that represented further violations of the insider lending and concentration of credit restrictions.[7] Then, on September 24, 1991, the Bank extended a $150,000 line of credit to Hedrick, and the next day advanced $36,000 to Hedrick under that line of credit. RD 65.[8] Respondents except to these findings on the ground that the violations are contingent on the finding that the Snyder loan is attributable to Hedrick, which the Board rejects for the reasons stated above. Hedrick also excepts on the ground that the position of chairman of the board is not an ''executive officer'' for purposes of Regulation O, an argument that is refuted by the plain terms of the regulation. *See* 12 C.F.R. 215.2(e)(1) (''executive officer'' defined to include chairman of the board unless excluded from participation by formal action).

In addition, Hedrick engaged in another nominee loan arrangement where he received the benefit of a loan made nominally to Virgil Parks, the manager of Sand Dune Shores, a Florida time share development in which Hedrick was involved. After the loan was made, the proceeds were used to pay down the amount outstanding on one of Hedrick's loans.[9] RD 70, 94; Jt. Stip. 14. The loan, accord-

7. The ALJ found that the extension of credit caused the total of loans and other extensions of credit outstanding to Hedrick to exceed the Bank's individual insider lending limit by $344,395 and the aggregate insider lending limit by $108,770. The total also exceeded the Bank's limit on loans to one borrower by about $43,070. RD 64.

8. The ALJ found that loans and other extensions of credit attributable to Hedrick after the $36,000 advance exceeded the Bank's limit to one borrower by about $22,865, exceeded the Bank's individual insider lending limit by about $438,678 and exceeded the Bank's aggregate insider lending limit by $188,678. RD 66–67.

9. This caused Hedrick's outstanding loan totals to remain constant, so that there was no further insider lending violation. But the ALJ found that the Bank lost value on the transaction because the loan purported to be secured by eight time share units in Sand Dune Shores, of which five had previously been assigned to the Bank. When the Parks loan was ultimately repaid by the Sand Dunes Shores

ingly, is a further illustration of the manner in which Hedrick casually shifted money between the Bank, his own accounts, and those of his business associates. Accordingly, the Board rejects the Respondent's exception that characterizes the OCC's charges in this respect as making a ''mountain out of a molehill''. Exceptions at 26–27.

The Board adopts the ALJ's conclusions of law with respect to the Snyder loan. The ALJ found that the Respondents' actions satisfied the misconduct element in that the loan represented a breach of fiduciary duty, an unsafe and unsound banking practice, and various violations of the banking laws regarding lending limits. RD 147, 153. The ALJ also found that Snyder breached his fiduciary duty to the Bank by allowing himself to be used as a nominee for Hedrick and not disclosing to the Bank the true purpose of the loan. RD 154. The Board agrees that it is an unsafe or unsound practice and a breach of fiduciary duty, as well as a violation of law,[10] to undertake a nominee loan scheme in which a loan is made for the benefit of an undisclosed person, thus preventing the bank from assessing the true risk or legal status of the loan. *United States v. Olson,* 825 F.2d 121, 123 (7th Cir. 1987), *citing United States v. Angelos,* 763 F.2d 859, 861 (7th Cir. 1985); *United States v. Hoffman,* 1996 WL 469901 *3 (4th Cir. 1996); *Feingold v. United States,* 49 F.3d 437, 440 (8th Cir. 1995); *United States v. Krepps,* 605 F.2d 101 (3d Cir. 1979). This particular loan was also unsafe or unsound in that it was severely undercollateralized.

The ALJ found that the Snyder loan satisfied the effects requirement in that the Bank lost $260,000 in principal and $52,081 in accrued interest on the Snyder loan, while Hedrick benefitted by securing the release of the Bank's lien on the Hoosier stock owned by Hedrick. RD 155. The ALJ found that Snyder benefitted by receiving appointment to the vice-chairmanship of the board of directors with a salary increase and health insurance benefits. RD 156.

The ALJ found that the Snyder loan satisfied the culpability requirement as to both Hedrick and Snyder. The ALJ found that the conduct of both Hedrick and Snyder willful and misleading in that they did not disclose to the board of directors the nominee nature of the loan. RD 159. The ALJ found that the continued failure to disclose the nature of the arrangement at the time of the further extensions of credit to Hedrick represented a continuing disregard for the safety and soundness of the Bank by both Hedrick and Snyder. The ALJ further found that the failure to disclose represented personal dishonesty by both Snyder and Hedrick. RD 160.

Accordingly, the Board finds that the Snyder loan transaction, standing alone, forms a sufficient basis for the prohibition of both Hedrick and Snyder from banking.

Condominium Association, the Bank thereupon returned to the condominium association the time share units that had nominally served as the collateral, including the five that in fact the Bank owned. RD 72; OCC Ex. 61. The ALJ found that the Bank lost the value of the five time share units. RD 72, 95.

10. *See* 18 U.S.C. § 656 (willful misapplication of bank funds).

3. Directors' Legal Fees

Apart from the Snyder loan transaction, the Board also concludes that Hedrick is subject to prohibition in connection with the diversion of Bank resources to pay the legal expenses of directors in contesting an OCC action seeking the imposition of civil money penalties. The Bank's payment of those fees violated an OCC regulation that strictly limits the circumstances under which a bank may reimburse such fees. The OCC regulation generally permits a bank to provide in its articles of association for the indemnification of directors, officers or employees for expenses reasonably incurred in actions arising out of the performance of their official duties. 12 C.F.R. 7.5217(a). The regulation specifies, however, that such indemnification shall not be allowed for ''expenses, penalties or other payments incurred in an administrative proceeding or action instituted by an appropriate bank regulatory agency which proceeding or action results in a final order assessing civil money penalties or requiring affirmative action by an individual or individuals in the form of payments to the bank.'' 12 C.F.R. 7.5217(b).

The ALJ found that Hedrick violated this regulation by negotiating the terms of legal representation in connection with administrative charges brought by the OCC in 1985. In that 1985 action, the OCC charged that the Bank had not complied with the terms of a cease and desist order previously imposed by consent, and brought a cease and desist action against the Bank accompanied by civil money penalty assessments of $15,000 against Hedrick and $10,000 each against five other directors. RD 8; OCC Ex. L-5. The Bank retained a law firm, Hartke & Hartke, to contest both the cease and desist charges on behalf of the Bank and the civil money penalty actions on behalf of the individual directors. Jt. Stip. 9, 10. The OCC withdrew its cease and desist action in March, 1986. At that time, the Bank owed the law firm $77,500 in unpaid legal fees. RD 13. The withdrawal of that action left pending only the civil money penalty action against the directors, in a cumulative amount of $65,000.

The five individual directors agreed to pay a flat fee of $1,500 apiece to Hartke & Hartke for representation in contesting the penalties, but the only payments the individuals ever made were $100 apiece by four of the directors, not including Hedrick. RD 13, 43; OCC Ex. L-13. Notwithstanding the absence of any pending proceeding against it, the Bank, pursuant to a 36-month representation agreement negotiated by Hedrick, continued for years to pay $6,000 a month in legal fees plus expenses to Hartke & Hartke for representation of the directors in the civil money penalty litigation. RD 16, 19–25. The civil money penalties were sustained by the Comptroller, affirmed on petition for review to the United States Court of Appeals for the Seventh Circuit, *Abercrombie v. Clarke,* 920 F.2d 1351 (7th Cir. 1990), and left undisturbed by the Supreme Court, which denied certiorari. 502 U.S. 809 (1991). Hedrick made independent decisions to authorize the legal fees and expenses for the attempt to seek rehearing in the Seventh Circuit and the attempt to seek certiorari, even though the Bank was not a party to those actions. RD 29, 43–44; Hedrick Tr. 862. The ALJ concluded that the total of fees and expenses paid by the Bank to contest the directors' civil money penalty action was $139,605. RD 45. The individual directors never reimbursed the Bank for those fees and expenses, as required by regulation. RD 32; OCC Ex. 53.[11]

The ALJ concluded that Hedrick violated the OCC's regulation regarding indemnity by negotiating an agreement with the Hartkes for the purpose of causing the Bank to pay the directors legal fees. RD 38. Under that agreement, the Bank improperly advanced to the directors payments for legal fees and expenses.[12] Hedrick also failed to reimburse the Bank for fees and expenses undertaken on his behalf after the OCC prevailed in its civil money penalty litigation, failed to take any action to cause the other directors to make reimbursement, and concealed the nature of the payments from the OCC. RD 46–48. The ALJ further found that the representation agreement, the advance of funds on behalf of the directors, and the failure to reimburse represented unsafe and unsound practices, especially in light of the Bank's financial condition and the failure to ascertain whether the directors possessed the ability to repay the advances. RD 146–147.

The ALJ found that the Bank sustained loss[13] as a result of the improper representation agreement, RD 145, and that Hedrick benefitted from the Bank's payment of fees and expenses on his behalf. RD 155.[14] The ALJ found that Hedrick's conduct in negotiating the Hartke fee arrangements and causing the Bank to pay the directors' legal fees evidenced willful and continuing disregard for the safety and soundness of the Bank. RD 158. The ALJ noted that Hedrick's subjective appreciation of the wrongfulness of his actions could reasonably be inferred from his attempts to disguise the nature of the Hartke fee agreement. RD 158; *see* RD 47–48.

In his exceptions, Hedrick argues that he reasonably relied upon the advice of counsel in negotiating the legal representation and that the allegations are time-barred under 18 U.S.C. § 2462 because the initial actions with respect to the fee arrangement took place more than five years before the notice of charges was issued by the OCC. The Board denies both exceptions.

Even if advice of counsel were a valid defense to the charges, it would be inapplicable here because substantial evidence supports Hedrick's awareness that the fee arrangement was improper. Hedrick is the person who negotiated the terms of the fee agreement with the Hartkes. RD 38. It is clear that Hedrick was made aware of the applicable regulation in that an OCC examiner pointedly left a copy of the regulation with Hedrick in December 1986. RD 38. Furthermore, the Hartkes made reference to the requirements of the regulation in various communications, including a letter advising Hedrick that civil money penalties must be paid by the individual directors, OCC Ex. L-9, and a letter advising that any fee amounts advanced by the Bank on behalf of individual directors were subject to reimbursement by the directors if the OCC prevailed. OCC Ex. L-32. Hedrick's awareness of the regulation's requirements is also displayed by the consideration given by the board of directors to amending the Bank's articles of association to provide for indemnification, as required by the regulation. RD 39; OCC Ex. L-7. It is also clear that Hedrick was aware that the $1,500 nominal amount charged the individual directors as a "flat fee" was a fiction, since he knew the amounts expended by the Bank after the Bank was no longer a party to the OCC action and he knew that the Hartkes had not been paid by the directors. RD 48. Accordingly the Board adopts the ALJ's rejection of the argument that advice of counsel served to negate Hedrick's misconduct with respect to the Bank's payment of fees for the directors.

The Board also finds that this charge is not precluded by application of the five-year statute of limitations in 18 U.S.C. § 2462. While the Board doubts that the statute of limitations applies to banking administrative enforcement actions generally,[15] and questions in particular its application to the remedial sanction of prohibition,[16] the Board concludes that these issues need not be resolved here because, on these facts, the prohibition cause of action in connection with the legal fees issue was not time-barred.

Because the OCC issued its prohibition notice against Hedrick on November 12, 1992, the statute of limitations,

11. The Hartkes settled an enforcement action by the OCC by agreeing to a suspension from practice before the OCC for two years and civil money penalties totalling $35,000. RD 36.

12. The Bank's articles of association never provided for indemnity, a prerequisite to the Bank's advance of legal fees to the directors for their individual litigation. 12 C.F.R. 7.5217(a). RD 39.

13. The Board need not consider OCC Enforcement Counsel's exceptions to the amount of the loss determined by the ALJ, since the precise amount of the loss is not relevant to the prohibition determination. *See* Exceptions at 2–5.

14. The Board adopts OCC Enforcement Counsel's exceptions in the nature of technical corrections that the ALJ used "Hartke" where he meant "Hedrick" in two instances on page 155 of the Recommended Decision. Exceptions at 10.

15. In *In re Interamericas Investments Ltd.*, 82 *Federal Reserve Bulletin* 609, 617 n.17, the Board questioned whether section 2462 should be applied to enforcement actions by the banking agencies under the Bank Holding Company Act and the Federal Deposit Insurance Act. The Board found it unnecessary to answer that question, however, since section 2462 was found not to bar the action for factual reasons. *Id.* at 617.

16. The limitations statute reads, in relevant part: "Except as otherwise provided by Act of Congress, an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued. . . . " 28 U.S.C. § 2462. The Board believes that the remedy of prohibition, which is designed to protect the banking industry against individuals found to have engaged in misconduct of a certain sort, is not a "fine, penalty or forfeiture" within the meaning of the statute. *Cf. U.S. v. Stoller,* 78 F.3d 710 (1st Cir. 1996) (prohibition order is remedial and not a "punishment" within the meaning of the double jeopardy clause); *Federal Election Commission v. Nat'l Republican Senatorial Committee,* 877 F. Supp. 15, 21 (D.D.C. 1995) (injunctive actions outside scope of section 2462); *but cf. Johnson v. SEC,* 87 F.3d 484 (D.C. Cir. 1996) (SEC broker suspension constitutes punishment and thus is subject to section 2462).

even if applicable, does not bar any cause of action that accrued after November 12, 1987. Here, while the advances were at all times unauthorized, this prohibition action did not fully accrue until the directors failed to reimburse the Bank following the exhaustion of appeals when the Supreme Court denied certiorari in October 1991. Had the OCC brought its charges before then, the unresolved contingency of reimbursement would have rendered judgments as to the degree of loss and nature of culpability tentative. The Board therefore finds that the prohibition cause of action for the unreimbursed legal fees did not accrue more than five years before the prohibition notice was issued.

Furthermore, the Board adopts the ALJ's conclusion that various actions taken by Hedrick to disguise the payment of legal fees by the Bank constituted fraudulent concealment that tolled the running of the statute of limitations. RD 46–48.[17] The ALJ found that Hedrick misled OCC examiners as to the nature of the services being provided for the fees, that the terms of the representation were not fully known within the Bank, and that Hedrick continued to conceal the purposes of the retainer agreement throughout the OCC's investigation. RD 46–48. Accordingly, the statute of limitations did not preclude this basis for prohibition.[18]

4. *Transactions With Affiliates*

In 1989, the Bank ''upstreamed'' $82,000 to Hoosier, its parent bank holding company, to be used for income tax payments. Jt. Stip. 32, 33. Because the Bank was operating at a loss, Hoosier was legally obligated to reimburse the Bank for any tax benefit. RD 95–96. Hoosier's inability to reimburse the Bank had the effect of creating an unsecured loan of $82,000 to an affiliate in violation of 12 U.S.C. § 371c. RD 96.

The OCC instructed the Bank to correct the violation. RD 96. In response, Hedrick caused the Bank to make an unsecured loan of $50,000 to a director of the Bank, the proceeds of which were deposited, along with funds from Hedrick, into a Hoosier account. RD 96, 100. Hoosier used those funds to reimburse the Bank, and the Bank reported to bank regulators that the violation had been corrected. RD 96; Jt. Stip. 35. In effect, then, Hedrick caused the Bank to fund its own repayment. Because Hoosier was the beneficiary of the loan, the loan represented another improper affiliate transaction and a new violation of 12 U.S.C. § 371c. *See* 12 U.S.C. § 371c(a)(2).

Similarly, the Bank upstreamed $47,134 in insurance premiums to Hoosier that Hoosier was unable to reimburse or collateralize in violation of 12 U.S.C. § 371c. RD 96; Jt. Stip. 36, 38. In response to OCC criticism in May 1990, Hedrick in December 1990 pledged two deposit accounts and another director pledged shares of stock to secure Hoosier's loan. RD 97. The stock pledge and one of Hedrick's account pledges were released when the balance in Hedrick's other account became sufficient to secure the loan to Hoosier. RD 97. The Bank retained a $50,000 hold on that account. RD 97. One week after the OCC had been informed of the substituted collateral, Hedrick ordered the hold on his account overridden to gain access to a portion of the frozen funds. RD 97, 101; Jt. Stip. 39. The withdrawal of funds from the account left the balance of the loan to Hoosier undersecured in another violation of 12 U.S.C. § 371c. RD 98. The violation was later cured by an additional deposit by Hedrick. RD 102.

The ALJ found that the transactions were unsafe and unsound, RD 149, and breaches of Hedrick's fiduciary duty to the Bank, RD 152, as well as violations of law. The ALJ found that the transactions caused financial gain to Hedrick in that he was Hoosier's principal shareholder and benefitted from the extinction of a Hoosier debt. RD 156. Hedrick also received financial gain from overriding the hold on his account to gain access to his funds. RD 156.

The ALJ found that Hedrick acted with personal dishonesty by claiming that the first affiliate transaction involving Hoosier was corrected, thereby misleading the OCC and the Board. RD 160. He also found that Hedrick displayed willful and continuing disregard for the safety and soundness of the Bank in both affiliate transactions. RD 183.

Hedrick's exceptions to the Recommended Decision argue that the affiliate transactions represent yet another instance of the OCC's making a ''mountain out of a molehill'' by mischaracterizing Hedrick's good-faith coping with a difficult financial situation. Exceptions 27–29. The Board rejects Hedrick's version, and finds that the facts with respect to the affiliate transactions underscore Hedrick's unwillingness or inability to observe the distinctions between the Bank's resources and his own.

5. *Sand Dune Shores*

Hedrick held an interest in a time-share apartment complex called Sand Dune Shores. RD 121. The ALJ found that Hedrick caused the Bank to engage in improper transactions that furthered Hedrick's interest in his investment rather than that of the Bank, while failing to disclose his personal interest or abstain from voting when the board of directors authorized the Bank to pay the taxes, interest and expenses of the development. RD 121. Hedrick also caused the Bank to purchase contracts from other banks to relieve Hedrick from obligations on guarantees.

Hedrick became the substitute general partner of Sand Dune Shores, Ltd. (''SDSL''), a limited partnership, in

17. In *3M Company (Minnesota Mining and Manufacturing) v. Browner,* 17 F.3d 1453 (1994), the D.C. Circuit ruled in a case involving the imposition of penalties by the Environmental Protection Agency that the limitations period applies, not just to court cases to collect penalties already assessed by agencies, but also to the agency adjudications themselves. The court noted, however, that the limitations period might be tolled in cases of fraudulent concealment. 17 F.3d at 1461 n.15.

18. Of course, as stated above, the Snyder loan transaction, as to which there is no limitations issue, independently constitutes a sufficient basis for prohibition.

1985, after the previous general partner had declared bankruptcy, after SDSL had become delinquent on federal taxes, and after the Bank's compliance committee had directed Hedrick to liquidate his interest in SDSL. RD 121–122; Jt. Stip. 48. The Bank held conditional sales contracts on SDSL time-share units valued at about $278,934. RD 122. Hedrick was the guarantor of conditional sales contracts on SDSL time-share units financed by financial institutions other than the Bank, aggregating to between $790,000 and $1,300,000 by September 1985. RD 133. Hedrick also held a number of SDSL time-share units for sale and testified that his personal Sand Dune Shores records were intertwined with those of the Bank. Hedrick Tr. 263–64.

From October 1986 until May 1988, the Bank paid approximately $407,242 in delinquent property taxes, interest, and other expenses of SDSL in order to protect its $214,000 interest in the sales contracts. RD 122–124. In return, the Bank received an assignment of SDSL's interest in 102 time-share units, nominally worth over $500,000, but ultimately worth far less. RD 124. In at least two of the meetings where the board of directors voted to authorize tax payments to Sand Dune Shores, Hedrick was present and voting. RD 124. The ALJ found that there was no evidence that the payments for the benefit of SDSL were to avoid lawsuits, and concluded that the payments were instead intended to protect Hedrick against loss. RD 134.

In 1988, the Bank paid $79,869 to another lender for additional SDSL time-share sales contracts that had been guaranteed by Hedrick, about half of which were characterized as ''bad accounts'' with a salvage value of about $18,000. RD 126. In 1989, the Bank purchased another 108 SDSL sales contracts from another lender for about $55,750. RD 127. In each case, the Bank's purchase relieved Hedrick of his liability on his guarantees. RD 126, 127; Jt. Stip. 54, 56. At the board of directors meetings where the purchases were authorized, Hedrick did not abstain from the vote to purchase the contracts. RD 127; Amy Tr. 1593–95; 1597–99. The ALJ concluded that the Bank ultimately charged off $406,000 on the Sand Dune Shores relationship, more than it would have lost if it had lost its interests in the sales contracts through tax foreclosure. RD 131, 137.

The ALJ found that Hedrick's conflicts of interest violated his fiduciary duty and caused the Bank to engage in unsafe and unsound practices because it lacked the information necessary to make an informed decision about its transactions. RD 137. The Bank lost more than $405,000 in Sand Dune Shores outlays and Hedrick received the benefit of being relieved of guarantees valued at between $790,000 and $1,300,000. RD 157. The ALJ concluded that Hedrick's conduct with respect to Sand Dune Shores represented personal dishonesty and willful and continuing disregard in that: he concealed the true purpose of the Bank's payments on behalf of SDSL; he failed to liquidate his interests in SDSL as directed by the Bank's compliance committee; and he continued to use the Bank to further his own interests and the interests of SDSL while the Bank lost substantial amounts of money. RD 161, 185.

Hedrick argues in his exceptions, first, that the OCC is raising events that occurred more than five years before charges were brought and therefore outside the statute of limitations. Exceptions at 32. As before, the Board need not address the applicability of the statute of limitations to prohibition actions, since a number of the charged actions took place after November 12, 1987 and therefore within a five-year period preceding the issuance of the prohibition notice.[19]

Hedrick also vigorously argues that the Sand Dune Shores relationship was in the best interests of the Bank, that the actions taken preserved the Bank's investment from foreclosure and protected the Bank against lawsuit. Exceptions at 32–37. Hedrick also argues, citing to his own testimony, that the other directors and Bank personnel were aware of Hedrick's positions with Sand Dune Shores. Exceptions at 37–38.

The Board rejects these exceptions, finding that Hedrick's role in causing the Bank to pour money into a project in which he had substantial financial exposure represents a classic example of financial self-dealing. Even if it were true as a matter of fact that other members of the board of directors were aware of the extent of his involvement in the project, that awareness was not documented in board minutes and no measures were taken to insulate Hedrick from voting on decisions that affected his interests. For purposes of this prohibition action, the precise amount lost by the Bank is not material, since it is clear that Hedrick received financial gain from the Bank's support of the project. Accordingly, the Board concludes that the Sand Dune Shores transactions constituted yet another independent basis for Hedrick's prohibition.

6. Summary

The Board concludes that substantial evidence in the record supports the issuance of an order of prohibition against Respondent Snyder for his role as a nominee in the Snyder loan, and against Respondent Hedrick for his participation in the Snyder loan and other lending and affiliate transaction violations, for orchestrating the Bank's payment of legal fees and expenses that were the responsibility of the directors, and for his self-dealing in transactions related to Sand Dune Shores.

Conclusion

For the foregoing reasons, the Board orders that the attached Order of Prohibition issue.

19. Board meetings where tax payments on behalf of Sand Dune Shores were authorized included March 26 and May 17, 1988. RD 124. The Bank purchased time-share unit sales contracts on which Hedrick was the guarantor on or about October 5, 1988, and June 1, 1989. RD 126, 127.

Order of Prohibition

WHEREAS, pursuant to section 8(e) of the Federal Deposit Insurance Act, as amended, (the "Act") (12 U.S.C. § 1818(e)), the Board of Governors of the Federal Reserve System ("the Board") is of the opinion, for the reasons set forth in the accompanying Final Decision, that a final Order of Prohibition should issue against DONALD E. HEDRICK and JOHN K. SNYDER;

NOW, THEREFORE, IT IS HEREBY ORDERED, pursuant to sections 8(b)(3), 8(e), and 8(j) of the Federal Deposit Insurance Act, as amended, (12 U.S.C. §§ 1818(b)(3), 1818(e) and 1818(j)), that:

1. In the absence of prior written approval by the Board, and by any other Federal financial institution regulatory agency where necessary pursuant to section 8(e)(7)(B) of the Act (12 U.S.C. § 1818(e)(7)(B)), DONALD E. HEDRICK and JOHN K. SNYDER are hereby prohibited:

(a) From participating in the conduct of the affairs of any bank holding company, any insured depository institution or any other institution specified in subsection 8(e)(7)(A) of the Act (12 U.S.C. § 1818(e)(7)(A));

(b) From soliciting, procuring, transferring, attempting to transfer, voting or attempting to vote any proxy, consent, or authorization with respect to any voting rights in any institution described in subsection 8(e)(7)(A) of the Act (12 U.S.C. § 1818(e)(7)(A));

(c) From violating any voting agreement previously approved by the appropriate Federal banking agency; or

(d) From voting for a director, or from serving or acting as an institution-affiliated party as defined in section 3(u) of the Act, (12 U.S.C. § 1813(u)), such as an officer, director, or employee.

2. This Order, and each provision hereof, is and shall remain fully effective and enforceable until expressly stayed, modified, terminated or suspended in writing by the Board.

This Order shall become effective upon the expiration of thirty days after service is made.

By Order of the Board of Governors, this 11th day of September, 1996.

Board of Governors of the
Federal Reserve System

WILLIAM W. WILES
Secretary of the Board

Final Enforcement Order Issued by the Board of Governors

National Bank of Greece
Athens, Greece

The Federal Reserve Board announced on September 13, 1996, the joint issuance with the Federal Deposit Insurance Corporation and the Commissioner of Banks for the Commonwealth of Massachusetts of a Cease and Desist Order against the National Bank of Greece, Athens, Greece, and the National Bank of Greece's branch in Boston.

The Federal Reserve Board also issued jointly with the Federal Deposit Insurance Corporation an Order of Assessment of a Civil Money Penalty against the National Bank of Greece and its Boston branch.