Volume 90 □ Number 3 □ Summer 2004

Federal Reserve BULLETIN

Board of Governors of the Federal Reserve System, Washington, D.C.

PUBLICATIONS COMMITTEE

Lynn S. Fox, *Chair* ☐ Sandra Braunstein ☐ Marianne M. Emerson ☐ Jennifer J. Johnson ☐ Karen H. Johnson ☐ Stephen R. Malphrus ☐ J. Virgil Mattingly, Jr. ☐ Vincent R. Reinhart ☐ Louise L. Roseman ☐ Richard Spillenkothen ☐ David J. Stockton

The *Federal Reserve Bulletin* is issued quarterly under the direction of the staff publications committee. This committee is responsible for opinions expressed except in official statements and signed articles. It is assisted by the Publications Department under the direction of Lucretia M. Boyer.

Table of Contents

265 *MONETARY POLICY REPORT TO THE CONGRESS*

The economic expansion in the United States became increasingly well established in the first half of 2004, but the pace of inflation picked up from its very low rate in 2003. At the time of the February *Monetary Policy Report to the Congress*, considerable evidence suggested that the U.S. economy had moved into a period of more-vigorous expansion. Nonetheless, some businesses remained cautious about hiring and investment. In the event, businesses stepped up their hiring in the spring, and capital spending seems to have continued apace.

Over the first half of this year, energy prices soared, and inflation in core consumer prices increased. To some extent, the upturn in core inflation reflected the indirect effects of higher energy prices. In addition, strengthening aggregate demand worldwide induced a surge in the prices of many primary commodities and industrial materials, and the decline in the dollar in 2003 put upward pressure on import prices. In this environment, firms were better able to pass on the higher costs of imports, raise the prices of domestically produced items that compete with imports, and in many cases boost their profit margins.

Monetary policy was very accommodative at the start of 2004 as the Federal Open Market Committee (FOMC) sought to provide continuing support to the economic expansion. Following some upbeat labor market reports, solid growth in output, and a pickup in core consumer price inflation, the FOMC announced at its May meeting that it believed that the monetary policy accommodation then in place could be "removed at a pace that is likely to be measured." At its June meeting, the FOMC decided to begin moving the federal funds rate back toward a more neutral setting.

Although some of the recent data have been on the soft side, the available information on the outlook for the U.S. economy is, on balance, positive. The prospects also seem favorable for inflation to remain contained in the period ahead.

289 *SUMMARY OF PAPERS PRESENTED AT THE CONFERENCE "MODELS AND MONETARY POLICY: RESEARCH IN THE TRADITION OF DALE HENDERSON, RICHARD PORTER, AND PETER TINSLEY"*

On March 26 and 27, 2004, the Federal Reserve Board held a conference in Washington, D.C., on the application of economic models to the analysis of monetary policy issues. The papers presented at the conference addressed several topics that, because they are of interest to central bankers, have been a prominent feature of Federal Reserve research over the years. In particular, the papers represent research in the tradition of work carried out over the past thirty-five years at the Federal Reserve by three prominent staff economists—Dale W. Henderson, Richard D. Porter, and Peter A. Tinsley. Thus, the conference partly served as a celebration of the contributions made by these individuals to policy-related research since the late 1960s.

Among the specific topics addressed at the conference were the influence of uncertainty on policymaking; the design of formal rules to guide policy actions; the role of money in the transmission of monetary policy; the determination of asset prices; and econometric techniques for estimating dynamic models of the economy.

297 *CREDIT REPORT ACCURACY AND ACCESS TO CREDIT*

Data that credit-reporting agencies maintain on consumers' credit-related experiences play a central role in U.S. credit markets. Analysts widely agree that the data enable these markets to function more efficiently and at lower cost than would otherwise be possible. Despite the great benefits of the current system, however, some analysts have raised concerns about the accuracy, timeliness, completeness, and consistency of consumer credit records and about the effects of data problems on the availability and cost of credit.

In this article, the authors expand on the available research by quantifying the effects of credit

record limitations on the access to credit. Using the credit records of a nationally representative sample of individuals, the authors examine the possible effects of data problems on consumers by estimating the changes in consumers' credit history scores that would result from "correcting" the problems in their credit records. Moreover, the authors report results for consumer groups segmented by strength of credit history (credit history score range), depth of credit history (number of credit accounts in a credit record), and selected demographic characteristics.

323 *REPORT ON THE CONDITION OF THE U.S. BANKING INDUSTRY: FIRST QUARTER, 2004*

Assets at reporting bank holding companies rose $325 billion (or 3.7 percent) in the first quarter of 2004 as the "fifty large" bank holding companies acquired investment securities as part of broader efforts to adjust interest rate sensitivity. Nonperforming assets and net charge-offs continued their sustained decline. Net income of reporting bank holding companies, which rose to nearly $30 billion for the quarter, was supported by stronger net interest income, lower provisions for loan losses, and significant gains associated with the sale of investment securities previously held in portfolio. More than one-third of the quarterly increase in net income was provided by "all other" bank holding companies as provisions for loan losses declined dramatically, in part because of seasonal influences. Earnings of these institutions had declined in the previous two quarters.

328 *STAFF STUDY SUMMARY*

Mergers and acquisitions have significantly changed the U.S. banking industry over the past quarter century. Staff Study 176, *Bank Merger Activity in the United States, 1994–2003*, analyzes patterns in detailed and comprehensive data for the 3,517 mergers consummated among commercial banks and thrift institutions from 1994 to 2003.

329 *ANNOUNCEMENTS*

Statement by Chairman Alan Greenspan on nomination for fifth term

Chairman Greenspan takes oath of office

Federal Open Market Committee statements

Proposed amendment to Regulation J

Amendments to Regulation V

Amendments to Regulation CC, Appendix A

Final amendments to Regulation CC and its commentary to implement Check 21 Act

Proposed amendments published to Regulation DD

Withdrawal of proposed revisions to Regulations B, E, M, Z, and DD

Intent to withdraw proposed amendments to Community Reinvestment Act regulations

Board of Governors requests comment

Proposed revision to policy statement on payments system risk

Proposed rule to retain trust preferred securities

Adequacy of existing disclosures of debit card fees

Prescreened solicitations for credit or insurance

Proposed revisions to bank holding company rating system

Bank Regulatory Agencies

Rollout delayed of web-based central data repository for bank financial data

Issuance of rules and guidance

Rule on use of medical information for credit eligibility

Guidance on overdraft protection programs

Rule on affiliate marketing opt outs

Final rule on capital requirements for asset-backed commercial paper programs

Bank Secrecy Act examination procedures

Regulatory agencies request comment

Statement concerning complex structured finance activities

Disposal of consumer information

Board begins 2004 Survey of Consumer Finances

Board begins Survey of Small Business Finances

Federal Reserve Banks announce strategy to meet evolving demands of payments system

Appointment of Jeffrey M. Lacker as President, Federal Reserve Bank of Richmond

Federal Open Market Committee schedule for 2005

United States unveils new $50 note

Businesses, banks, and cash-handling equipment manufacturers get final alert to prepare for new $50 note

Publication of revised capital framework and U.S. implementation plans

Publication of the May 2004 update to the *Commercial Bank Examination Manual*

Publication of the June 2004 update to the *Bank Holding Company Supervision Manual*

Support of plan to develop new central banking publication

Release of minutes to discount rate meetings

Announcement of meeting of the Consumer Advisory Council

Board seeks nominations for appointment to Consumer Advisory Council

Board closed on day of mourning

Enforcement actions

Changes in Board staff

352 Legal Developments

Various bank holding company, bank service corporation, and bank merger orders

420 *BOARD OF GOVERNORS AND OFFICIAL STAFF*

422 *FEDERAL OPEN MARKET COMMITTEE AND STAFF; ADVISORY COUNCILS*

424 *FEDERAL RESERVE BOARD PUBLICATIONS*

426 *ANTICIPATED SCHEDULE OF RELEASE DATES FOR PERIODIC RELEASES*

428 *MAPS OF THE FEDERAL RESERVE SYSTEM*

430 *FEDERAL RESERVE BANKS, BRANCHES, AND OFFICES*

Monetary Policy Report to the Congress

Report submitted to the Congress on July 20, 2004, pursuant to section 2B of the Federal Reserve Act

MONETARY POLICY AND THE ECONOMIC OUTLOOK

The economic expansion in the United States became increasingly well established in the first half of 2004, but the pace of inflation picked up from its very low rate in 2003. At the time of the February *Monetary Policy Report to the Congress*, considerable evidence was already in hand indicating that the U.S. economy had made the transition from a period of subpar growth to one of more-vigorous expansion. Nevertheless, job creation remained limited, and gains in investment, although sizable, still seemed restrained by a lingering caution on the part of some businesses. In the event, businesses stepped up their hiring in the spring, and capital spending seems to have continued apace.

Over the first half of this year, energy prices soared; moreover, inflation in core consumer prices—as measured by the price index for personal consumption expenditures excluding the direct effects of movements in food and energy prices—increased from an exceptionally low rate of 1 percent over the four quarters of 2003 to an annual rate of a little more than 2 percent. To some extent, the upturn in core inflation reflected the indirect effects of higher energy prices, but other forces also played a role. Strengthening aggregate demand both at home and abroad induced a surge in the prices of many primary commodities and industrial materials. In addition, the decline in the foreign exchange value of the dollar in 2003 put upward pressure on the prices of imported goods and services. With strong demand in the United States and increased utilization of the productive capacity of the economy, firms were better able to pass on the higher costs of imports, raise the prices of domestically produced items that compete with imports, and in many cases boost their profit margins. Likely in response to the faster rate of price increases experienced this year, surveys suggest that near-term inflation expectations have moved up somewhat; still, expectations for price inflation over the longer term have remained in their recent range.

Monetary policy was very accommodative at the start of 2004 as the Federal Open Market Committee (FOMC) sought to provide continuing support to an economic expansion that had yet to produce a sustained improvement in the labor market and to ensure that the previous year's threat of an unwelcome disinflation would continue to recede. Although real GDP had accelerated sharply in the second half of 2003, the incoming data through the time of the March meeting suggested that employment was growing only slowly, as employers were relying on increased production efficiencies to satisfy considerable gains in aggregate demand. Surging oil prices were boosting overall inflation, while core inflation—though no longer declining—was still low. With subsequent labor market reports suggesting that hiring was on a stronger track, growth in output continuing at a solid pace, and core consumer price inflation possibly running higher, the FOMC announced in May that it saw the risks to the goal of price stability as having moved into balance. Even so, the Committee stated that it believed that the monetary policy accommodation then in place could be "removed at a pace that is likely to be measured." Indeed, at its June meeting, the FOMC decided that sufficient evidence was in hand to begin moving the federal funds rate back toward a more neutral setting and raised the federal funds rate ¼ percentage point to 1¼ percent, a decision that was widely anticipated by market participants.

Although some of the recent data have been on the soft side, the available information on the outlook for the U.S. economy is, on balance, positive. Households are enjoying a generally improving job market, rising real incomes, and greater wealth, all of which are providing them with the confidence and wherewithal to spend. In the business sector, capital spending apparently is continuing to increase briskly, bolstered by expectations of strong sales as well as by booming profits and supportive financial conditions; investment should also continue to be buoyed by firms' adoption of productivity-enhancing technologies. Moreover, inventories appear to be lean relative to sales even after taking account of the substantial improvements firms have made in managing their stocks, suggesting that stockbuilding may provide some impetus to production in the near term. The

brightening outlook for economic activity abroad suggests that demand for U.S. exports should grow and provide a further lift to domestic production.

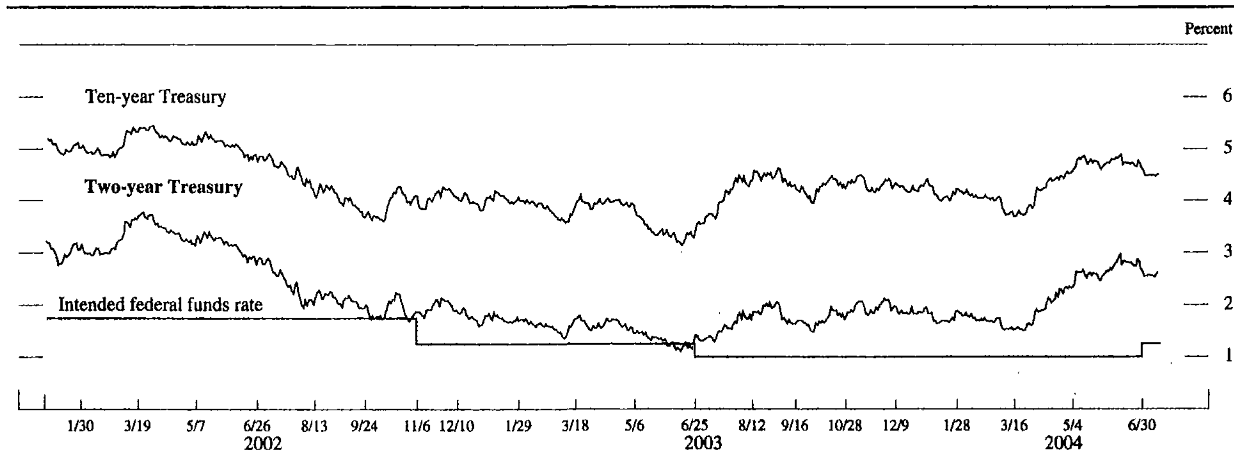
The prospects also seem favorable for inflation to remain contained in the period ahead. For one reason, some of the forces that contributed to the upturn in core inflation in the first half of 2004 are likely to prove transitory. In particular, the upward impetus from the rise in energy and commodity prices is likely to lessen in coming quarters. For another reason, the evidence suggests that the productive capacity of the economy is still not being fully used and that the attendant slack is probably exerting some downward pressure on inflation. If—as seems likely—the economy approaches full utilization of its productive capacity only gradually, that downward pressure should persist for a time. Moreover, productivity remains on a solid uptrend and should continue to restrain costs. To date, the gains in productivity have helped to boost profit margins. As firms compete to take advantage of profit opportunities, they may eventually be forced to absorb a portion of any increases in labor and other costs that occur. But history suggests that the absorption of costs has limits. Indeed, unit labor costs have turned up of late, as productivity growth has slowed below the rate of increase in hourly compensation. If increases in those costs were to develop any upward momentum, the well-behaved nature of inflation in recent years could be jeopardized.

Monetary Policy, Financial Markets, and the Economy over the First Half of 2004

At the beginning of 2004, the FOMC was growing more confident that the economic expansion was likely to be self-sustaining, particularly in light of the significant firming of business outlays and the continued strength in household spending. Moreover, stimulative fiscal and monetary policies, in conjunction with receptive financial markets, appeared likely to provide substantial support to economic activity and to ward off any further disinflation. However, the Committee remained concerned about the persistent weakness in the labor market. At its January meeting, the FOMC left the target for the federal funds rate at 1 percent. The Committee generally felt that the apparent slack in labor and product markets and continued strong productivity growth were likely to keep the underlying trend in inflation subdued, but it nevertheless was cognizant that a highly accommodative stance for monetary policy could not be maintained indefinitely. Given these considerations, the Committee modified the language of its policy statement to gain greater flexibility to firm policy should circumstances warrant. The Committee achieved this added flexibility by removing its assessment that monetary policy would be accommodative for "a considerable period" and instead saying that the Committee could be "patient" in removing its policy accommodation.

At the time of the March FOMC meeting, the Committee believed that conditions were mostly in place for further solid economic growth. Industrial production had picked up broadly, and consumer and business spending continued to expand briskly. However, the employment reports for January and February still painted a picture of subdued hiring. With financial markets quite accommodative, the Committee recognized that maintaining the current stance of policy could fuel inflation pressures and perhaps encourage excessive risk-taking by financial market

Selected interest rates



NOTE. The data are daily and extend through July 14, 2004. The dates on the horizontal axis are those of FOMC meetings.

participants. The Committee concluded that the low level of core consumer price inflation and continued evidence of weak hiring argued for the retention of both its 1 percent target for the federal funds rate and the wording in its statement that the Committee could be "patient" with respect to changes in monetary policy.

At the May FOMC meeting, members noted a distinct improvement in the economic outlook. The labor market figures reported for March had proved to be strong, and the reports for the two previous months had been revised upward significantly. Consumer price inflation in the first quarter of the year was faster than it had been in the previous quarter. Although much of this rise was due to escalating energy costs, core inflation also stepped up, and survey-based measures of near-term inflation expectations had edged higher. In response to the indications of rising aggregate demand and a strengthening job market, yields on Treasury securities had risen appreciably. Accordingly, the Committee was of the view that the expansion would be vigorous and believed that the odds of any further disinflation had been substantially reduced. On the basis of the evolving outlook for economic activity and prices, the Committee revised its assessment of risks to indicate that the upside and downside risks for inflation had moved into balance. To underscore its belief that policy would probably soon need to move toward a more neutral stance while emphasizing that this process was not expected to be rapid, the Committee stated its judgment that monetary policy accommodation "can be removed at a pace that is likely to be measured."

At the time of the June FOMC meeting, incoming information tended to confirm that the economy was expanding at a solid pace but also indicated that inflation was higher than had been anticipated. Quotes on near-term money market futures and options suggested that market participants were nearly certain of an increase of 25 basis points in the target for the federal funds rate at that meeting and had priced in a cumulative increase of about 2¼ percentage points in the federal funds rate over the next year. The Committee agreed that the current substantial degree of policy accommodation was no longer warranted and decided to increase its target for the federal funds rate 25 basis points. The Committee noted that it considered the risks to both sustainable economic growth and stable prices to be roughly balanced and maintained its appraisal that policy accommodation "can be removed at a pace that is likely to be measured" but also emphasized that it will "respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability."

Economic Projections for 2004 and 2005

In conjunction with the FOMC meeting at the end of June, the members of the Board of Governors and the Federal Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, were asked to provide economic projections for 2004 and 2005. The central tendency of the FOMC participants' forecasts for the increase in real GDP is 4½ percent to 4¾ percent over the four quarters of 2004 and 3½ percent to 4 percent in 2005. The civilian unemployment rate is expected to lie between 5¼ percent and 5½ percent in the fourth quarter of 2004 and to decline to between 5 percent and 5¼ percent by the fourth quarter of 2005.

Starting with this report, the Federal Reserve will provide projections for the price index for personal consumption expenditures excluding food and energy (core PCE), which the Committee believes is better as an indicator of underlying inflation trends than is the overall PCE price measure previously featured. Core PCE inflation appears to have run a little above an annual rate of 2 percent in the first half of 2004; for 2004 as a whole, most FOMC participants expect it to lie between 1¾ percent and 2 percent. For 2005, the central tendency of the projections for core PCE inflation is 1½ percent to 2 percent.

Economic projections for 2004 and 2005
Percent

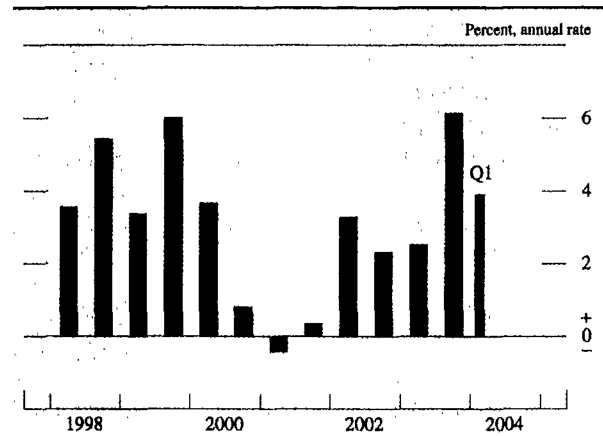
Indicator	Federal Reserve Governors and Reserve Bank presidents	
	Range	Central tendency
	2004	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	6–7	6¼–6¾
Real GDP	4–4¾	4½–4¾
PCE price index excluding food and energy	1½–2	1¾–2
Average level, fourth quarter		
Civilian unemployment rate	5¼–5½	5¼–5½
	2005	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	4¾–6½	5¼–6
Real GDP	3½–4	3½–4
PCE price index excluding food and energy	1½–2½	1½–2
Average level, fourth quarter		
Civilian unemployment rate	5–5½	5–5¼

1. Change from average for fourth quarter of previous year to average for fourth quarter of year indicated.

Economic and Financial Developments in 2004

After having surged in the second half of 2003, economic activity continued to expand at a solid pace in the first half of 2004. In the labor market, payroll employment started to increase last fall after a long string of declines and picked up further during the first half of this year. Headline inflation has been boosted significantly by the jump in energy prices this year, but core inflation has also moved up from the exceptionally low levels of late 2003.

Change in real GDP



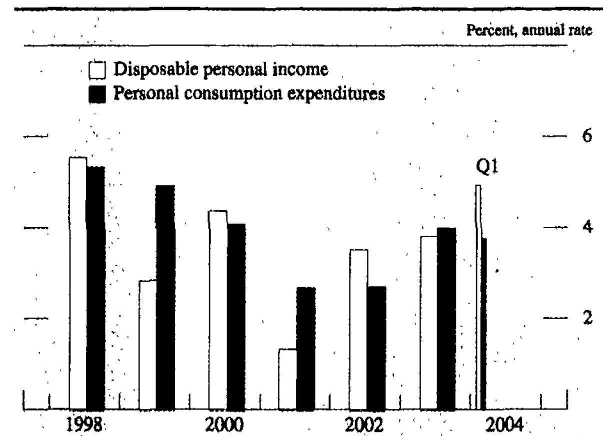
Note. Here and in subsequent charts, except as noted, change for a given period is measured to its final quarter from the final quarter of the preceding period.

The Household Sector

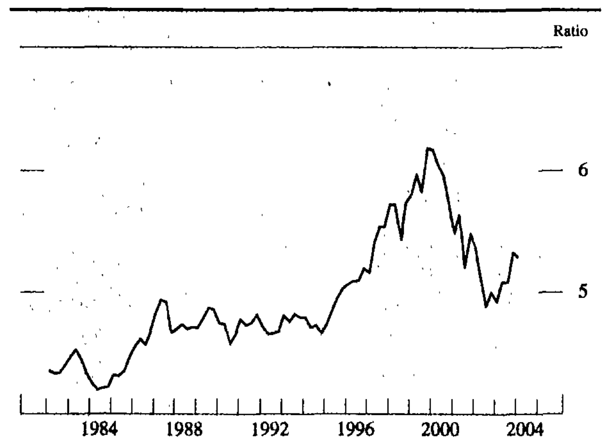
Consumer Spending

Consumer spending, which had gathered a good bit of steam in the second half of 2003, continued to move higher in the first half of 2004. The growth in

Change in real income and consumption



Wealth-to-income ratio

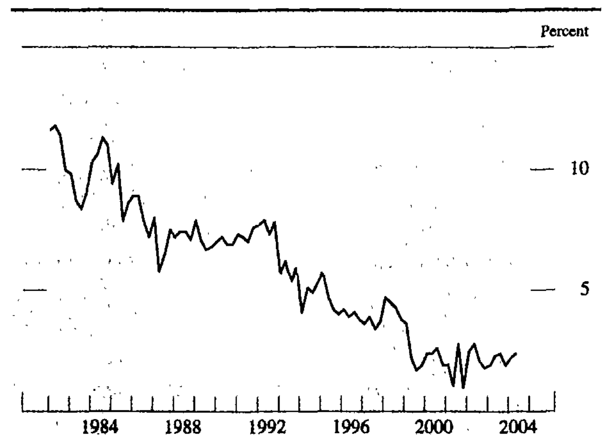


Note. The data are quarterly and extend through 2004:Q1. The wealth-to-income ratio is the ratio of household net worth to disposable personal income.

spending was spurred by substantial gains in income. In addition, household wealth has risen sharply over the past year, and consumer surveys indicate that individuals are generally upbeat in their assessments of the economy's prospects and of their own situations.

Personal consumption expenditures rose at an annual rate of 3¾ percent in real terms in the first quarter. Spending on light motor vehicles, which had been supported in late 2003 by aggressive price and financing incentives, slipped somewhat in early 2004. But outlays for goods other than motor vehicles, which had risen 6½ percent in real terms in 2003, posted another huge increase in the first quarter; spending on services also perked up after having advanced only modestly in 2003. The available data point to a much smaller increase in consumer spend-

Personal saving rate



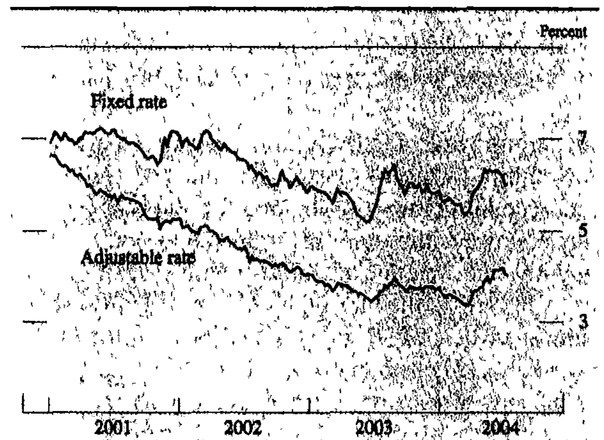
Note. The data are quarterly; the reading for 2004:Q2 is the average for April and May.

ing in the second quarter; the deceleration mainly reflects a sharp slowing in the growth of outlays on goods other than motor vehicles

Real disposable personal income (DPI)—that is, after-tax income adjusted for inflation—rose at an annual rate of nearly 4 percent between the fourth quarter of 2003 and May 2004, a gain about in line with its rate of growth last year. To be sure, the rise in energy prices cut into the growth of real income in the first half of the year. However, aggregate wages and salaries, boosted by increases in both employment and earnings, rose appreciably in nominal terms. In addition, last year's tax legislation, which had already reduced withholding rates in mid-2003, added further to households' cash flow by increasing refunds and lowering final settlements this spring.

Household wealth increased only about in line with nominal DPI in the first quarter of 2004, and the wealth-to-income ratio was likely little changed in the second quarter as well. Nonetheless, the increase in wealth over the past year has been considerable—and probably large enough to more or less offset any lingering restraint on spending growth from the earlier declines in stock prices. Thus, with wealth approximately a neutral influence on the growth of spending of late, the personal saving rate has held fairly steady. In fact, the average saving rate over the first five months of the year—at 2¼ percent of DPI—was very close to the annual figures for 2002 and 2003.

Mortgage rates

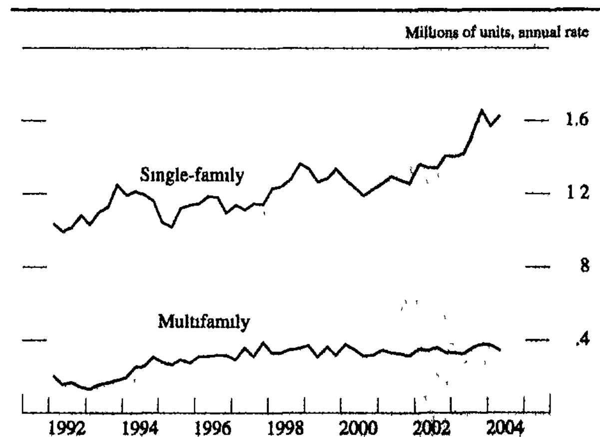


NOTE The data, which are weekly and extend through July 14, 2004, are contract rates on thirty-year mortgages
SOURCE Federal Home Loan Mortgage Corporation

Residential Investment

Activity in the housing sector remained torrid in the first half of 2004. Although starts in the single-family sector faltered a bit early in the year, in part because of unusually adverse weather, they subsequently snapped back and reached an annual rate of more than 1.6 million units in April and May—8½ percent greater than the already rapid pace for 2003 as a whole. Sales of new and existing homes have also been exceptionally strong, and they hit record highs in May. In general, housing activity has been supported by the favorable developments regarding jobs and income and, especially early in the year, by low mortgage rates. Rates on thirty-year fixed-rate mortgages, which had dipped to 5½ percent in March, rose markedly in the spring; they have edged down in recent weeks and now stand at 6 percent, a level still quite low by historical standards

Private housing starts



NOTE The data are quarterly, the readings for 2004 Q2 are the averages for April and May

Home prices have continued to rise rapidly For example, the national repeat-sales price index from the Office of Federal Housing Enterprise Oversight—which partially adjusts for shifts in the quality of homes sold—rose 7¾ percent over the year ending in the first quarter (the latest available data), a rate similar to the average annual gain since late 2000. By this measure—and many others—house price increases have outstripped gains in incomes as well as in rents in recent years.

Starts in the multifamily sector averaged an annual rate of 360,000 units over the first five months of the year, a pace slightly faster than that of the past several years. Low interest rates have apparently helped maintain the profitability of apartment construction, given that other fundamental determinants of activity in the sector have been weak: In particular, rents have remained soft, and in the first quarter, vacancy rates for multifamily rental properties reached a new high.

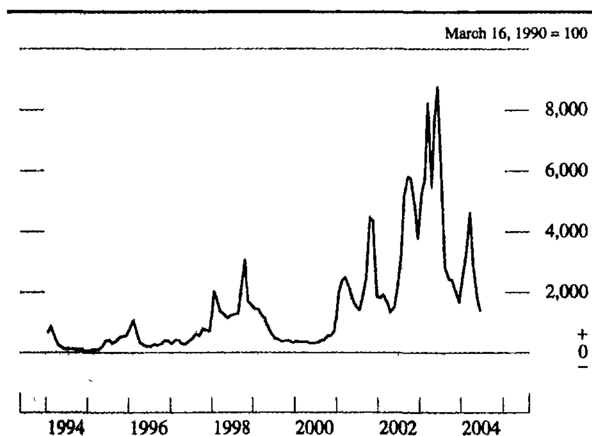
Household Finance

Household debt rose at an annual rate of about 10¾ percent in the first quarter of 2004 The especially rapid growth of mortgage debt was driven by the strong pace of activity in the housing market and the renewed wave of mortgage refinancing However, the second-quarter rise in interest rates appears to have slowed the rate of refinancing and, consequently, the amount of equity being extracted from the value of homes through such transactions. Consumer credit—which constitutes the bulk of household debt aside from mortgage borrowing—expanded at an annual rate of about 6 percent over the first quarter of the year and at roughly a 4 percent pace in April and May. The growth of consumer credit likely has continued to be restrained by the substitution toward mortgage debt as a means to finance household expenditures.

Low interest rates, in concert with strong growth in disposable personal income, have helped to keep financial obligations manageable for most households. In the first quarter of the year, the debt service ratio and the financial obligations ratio for the household sector in the aggregate, both of which gauge pre-committed expenditures relative to disposable income, continued to edge down from their peaks in 2001. Other indicators also suggest that the financial well-being of households has stabilized and may be improving. Delinquencies on credit card and auto loans generally declined in the first three months of the year, and bankruptcy rates, while still high, stepped down in the first quarter from their recent peak

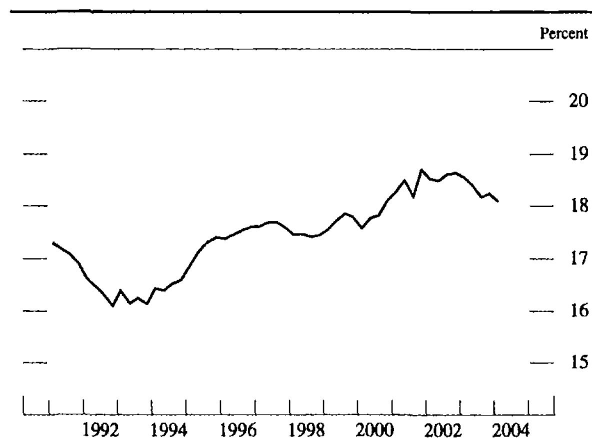
Rapid increases in home prices have continued to buoy household net worth this year In contrast, stock

Mortgage refinancing application index



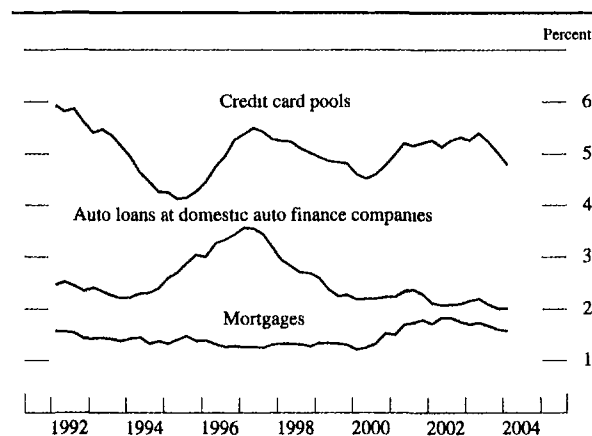
NOTE The data are monthly and extend through June 2004
SOURCE Mortgage Bankers Association

Household financial obligations ratio



NOTE The data are quarterly and extend through 2004 Q1 The financial obligations ratio equals the sum of required payments on mortgage and consumer debt, automobile leases, rent on tenant-occupied property, homeowners' insurance, and property taxes, all divided by disposable personal income

Delinquency rates on selected types of household loans



NOTE The data are quarterly and extend through 2004 Q1
SOURCE For mortgages, the Mortgage Bankers Association, for auto loans, the Big Three automakers, for credit cards, Moody's Investors Service

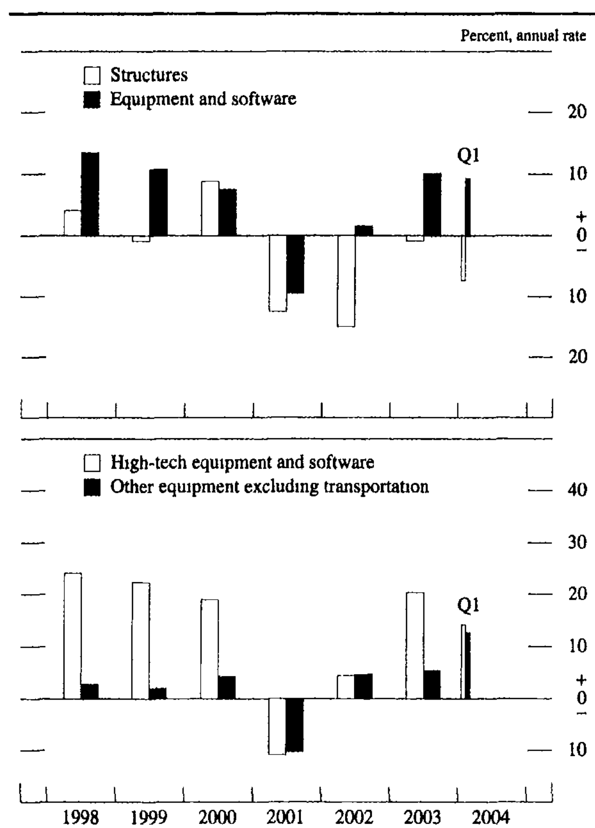
prices are about unchanged. Although news on earnings and economic activity has generally been favorable, rising oil prices and interest rates and, perhaps, heightened geopolitical concerns have weighed on investor sentiment Nevertheless, inflows into equity mutual funds have been even stronger thus far in 2004 than they were last year.

The Business Sector

Fixed Investment

For the most part, businesses appear to be shaking off the extraordinary reluctance to undertake new investment projects that was evident in 2002 and 2003.

Change in real business fixed investment



NOTE High-tech equipment consists of computers and peripheral equipment and communications equipment

Indeed, although outlays on nonresidential construction have not yet turned up decisively, real spending on equipment and software (E&S) has been advancing briskly. The broadly based growth in E&S spending has been driven by increasingly favorable fundamentals: positive expectations for sales, high levels of corporate profits and cash flow, a desire to replace or upgrade aging equipment after a period of weak investment spending, and the continued low cost of capital.

Real E&S spending rose at an annual rate of more than 15 percent in the second half of last year, and it posted another sizable increase in the first quarter of 2004 despite flat business purchases of motor vehicles and a dip in deliveries of aircraft. Excluding transportation equipment, real spending on E&S rose at an annual rate of 13½ percent in the first quarter. In the high-tech category, real purchases of computers and software remained on the solid uptrend that has been evident for the past couple of years, and real outlays on communications equipment increased further, reaching a level about 20 percent above the low in the fourth quarter of 2002 Spending for equipment other than high-tech and transportation, which accounts for about 40 percent of E&S (measured in nominal terms), also rose markedly in the first quarter. Such spending tends to be particularly sensitive to the prospects for aggregate demand In addition, it may be receiving a lift from the partial-expensing tax provision, which is especially valuable for equipment with relatively long service lives for tax purposes; that provision is slated to expire at the end of 2004.

Equipment spending appears to have posted another solid increase in the second quarter. Outlays on transportation equipment seem to have rebounded, and the incoming data on high-tech equipment point to robust real expenditures. Some indicators for spending on other nontransportation equipment have been a bit soft recently. But the May level of shipments for this broad category was still above that of the first quarter, and backlogs of unfilled orders, which have risen impressively over the past year, continued to build.

Real nonresidential construction has remained about unchanged, on net, since the steep decline in 2001 and 2002 Construction of office buildings is still running at roughly half the pace of 2000, although vacancy rates have stabilized—albeit at very high levels—and the decline in rents has slowed Factory construction also remains sluggish. Construction of retail and wholesale facilities, in contrast, has held up fairly well, a performance consistent with the strength in consumer spending. Outlays on buildings for health care and education also have been reasonably well sustained

Inventory Investment

Inventory investment has generally remained subdued even as final sales have strengthened Although real nonfarm inventory investment picked up to an annual rate of $30 billion in the first quarter, the accumulation occurred almost entirely in the motor vehicle sector, in which sagging sales and a high level of production early in the year created a noticeable bulge in dealer stocks, especially of light trucks. In the second quarter, the automakers reduced assemblies; but with sales running only a little above their first-quarter pace on average, inventories of motor vehicles remained elevated. Outside the motor vehicle industry, nonfarm inventories increased at a meager $6 billion annual rate in real terms in the first quarter, and the available data point to only a moderate step-up in real stockbuilding, on balance, in April and May. In general, non-auto inventories appear lean relative to sales, even after factoring in the

downward trend in inventory–sales ratios that has accompanied the ongoing improvements in supply-chain and logistics management

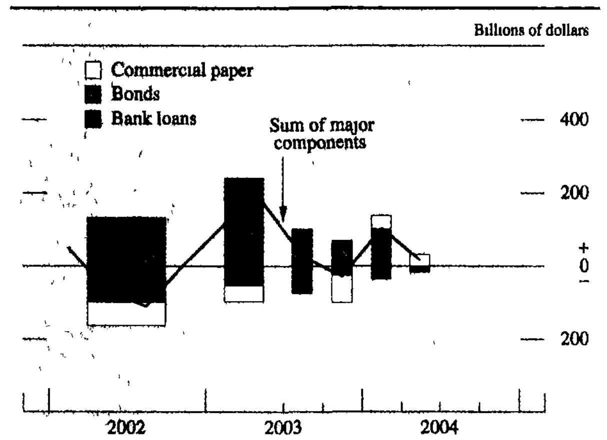
Corporate Profits and Business Finance

Continuing the gains of last year, profits of the business sector to date have remained strong. In the first quarter of 2004, earnings per share for S&P 500 firms were about 26 percent higher than their level four quarters earlier, and before-tax profits of nonfinancial corporations as a share of GDP from that sector edged up following a steep increase in 2003 A jump in profits in the petroleum and gas industries owing to higher oil prices was responsible for much of the rise in earnings However, firms across many industries, with the notable exception of telecommunication services, registered solid gains in earnings. In response to this pattern of higher profits, analysts have been steadily marking up their forecasts for earnings in subsequent quarters.

Net equity issuance has remained negative this year. Seasoned offerings have been scarce, the pace of initial public offerings has only inched up, and share retirements have continued to be strong. Corporations have continued to repurchase shares at a rapid rate to manage their cash positions, even as they have increased dividend payments

Firms relied heavily on their elevated profits and substantial cash holdings to finance their investment in inventories and fixed capital in the first half of 2004. As a result, the growth of nonfinancial business debt remained modest Much of the proceeds from

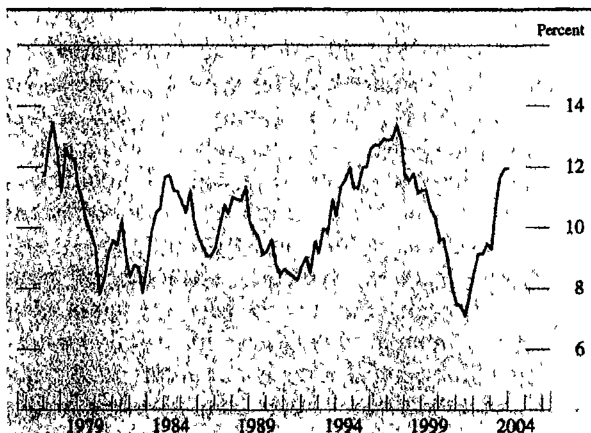
Major components of net business financing



Note Seasonally adjusted annual rate for nonfinancial corporate business The data for the sum of major components are quarterly The data for 2004 Q2 are estimated

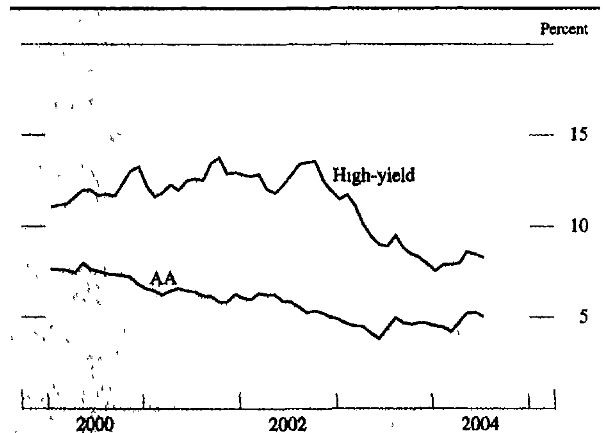
bond issuance was used to pay down higher-cost debt, and the timing of the issuance of investment-grade bonds in particular was influenced by movements in interest rates, issuance spiked in March in the wake of the drop in yields but subsided in April as rates rebounded. Short-term debt financing showed signs of turning around after contracting over the previous three years. Commercial paper outstanding expanded in the first two quarters of 2004. Business loans at banks have fallen on balance so far this year but at a much slower pace than in 2003. The Federal Reserve's Senior Loan Officer Opinion Survey conducted in April 2004 indicated that demand for business loans had begun to expand and that commercial banks had again eased both standards and terms on these loans over the previous three months.

Before-tax profits of nonfinancial corporations as a percent of sector GDP



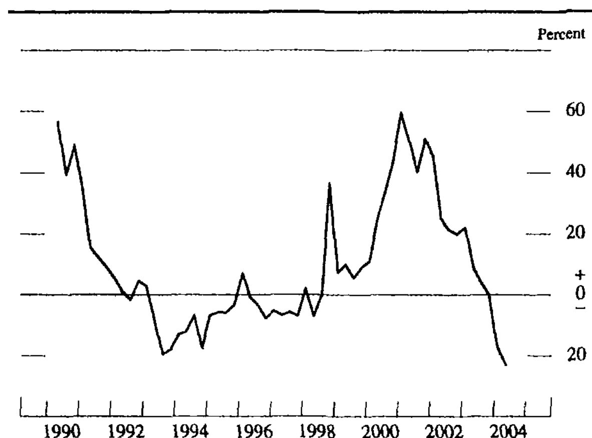
Note The data are quarterly and extend through 2004 Q1 Profits are from domestic operations of nonfinancial corporations, with inventory valuation and capital consumption adjustments

Corporate bond yields



Note The data are monthly averages of daily data The final observation is the average of trading days through July 14, 2004 The AA rate is the Merrill Lynch AA index with a remaining maturity of seven to ten years The high-yield rate is the yield on the Merrill Lynch 175 high-yield index

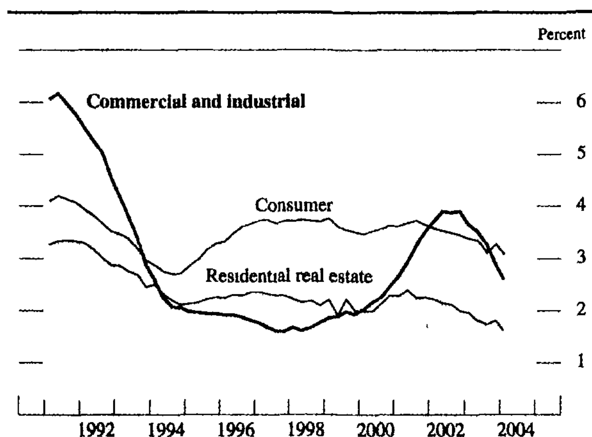
Net percentage of domestic banks tightening standards on commercial and industrial loans to large and medium-sized firms



NOTE The data are based on a survey generally conducted four times per year, the last reading is from the April 2004 survey Large and medium-sized firms are those with annual sales of $50 million or more Net percentage is the percentage reporting a tightening less the percentage reporting an easing
SOURCE Federal Reserve, Senior Loan Officer Opinion Survey on Bank Lending Practices

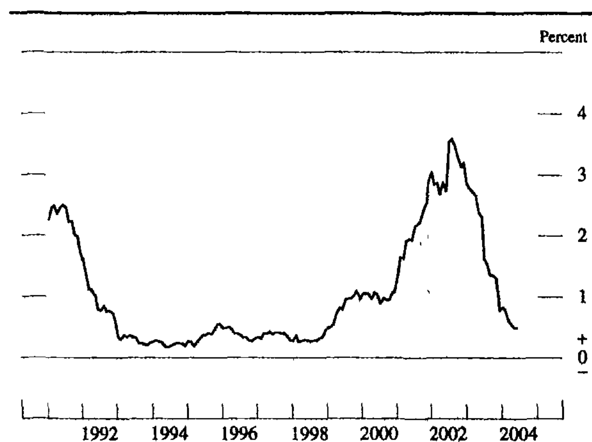
Strong profits, low interest rates, and continued deleveraging helped improve the credit quality of nonfinancial firms over the first half of the year. In the second quarter, the delinquency rate on business loans dropped for the sixth consecutive quarter; the continued decline has reversed a large part of the preceding run-up. Early in the year the twelve-month trailing default rate on outstanding bonds fell into the relatively low range observed over much of the 1990s, and in June it registered another decline. Moreover, in the first part of the year, the pace of upgrades of bond ratings by Moody's Investors Service rose while the pace of downgrades fell.

Delinquency rates on selected types of loans at banks



NOTE The data, from bank Call Reports, are quarterly, are seasonally adjusted, and extend through 2004 Q1

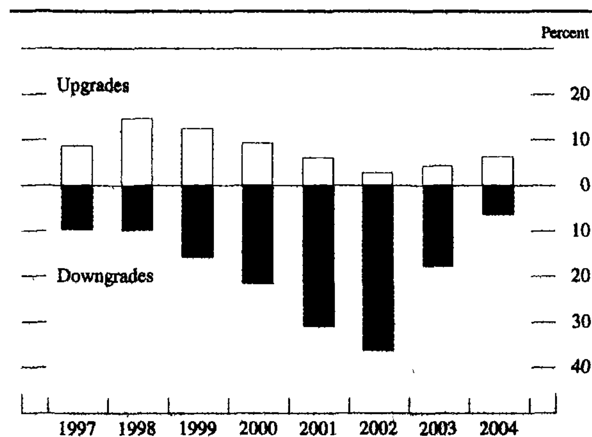
Default rate on outstanding bonds



NOTE The default rate is monthly and extends through June 2004 The rate for a given month is the face value of bonds that defaulted in the twelve months ending in that month divided by the face value of all bonds outstanding at the end of the calendar quarter immediately preceding the twelve-month period
SOURCE Moody's Investors Service

Borrowing against commercial real estate assets continued at a rapid pace during the first half of this year Anecdotal reports suggest that some firms were using mortgages on commercial property to lock in low-cost, long-term funding. Despite the persistently high vacancy rates for most types of commercial property, the loans backed by these assets have continued to perform well Delinquency rates on commercial mortgages held by banks and insurance companies remained very low in the first quarter. A drop in delinquencies on commercial-mortgage-backed securities (CMBS) in recent months has partially reversed last year's rise, and the narrow risk spreads

Ratings changes of nonfinancial corporate bonds



NOTE Data are at an annual rate, for 2004, they are the annualized values of monthly data through May Debt upgrades and downgrades are expressed as a percentage of the par value of all bonds outstanding
SOURCE Moody's Investors Service

on CMBS suggest that investors have limited concerns about loan quality

The Government Sector

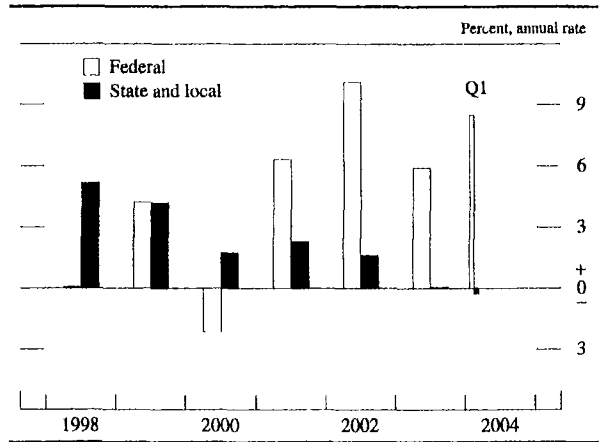
Federal Government

The deficit in the federal unified budget has continued to widen. Over the twelve months ending in June, the unified budget recorded a deficit of $431 billion, $120 billion more than during the comparable period last year and equal to nearly 4 percent of nominal GDP In large part, the rise in the deficit is attributable to further rapid increases in spending on defense and other programs and the loss of revenues resulting from the tax legislation enacted in recent years. In addition, interest costs, which fell sharply between fiscal 1997 and fiscal 2003 as a result of budget surpluses and declining interest rates, have leveled off and thus are no longer a significant factor helping to restrain the deficit The primary deficit, which excludes net interest, totaled $276 billion over the twelve months ending in June, also approximately $120 billion more than over the year ending in June 2003

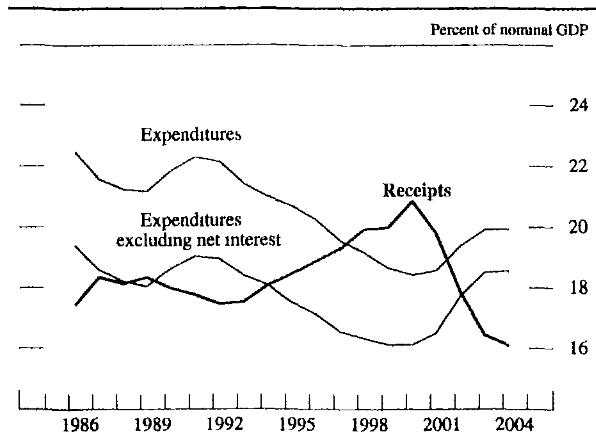
Over the twelve months ending in June, nominal federal spending was nearly 7 percent higher than during the same period a year earlier and stood at about 20 percent of nominal GDP—virtually the same as in fiscal 2003 but 1½ percentage points above the recent low in fiscal 2000. Spurred by the war in Iraq, defense spending ramped up another 14 percent; outlays for nondefense discretionary programs, which include homeland security, moved up further as well. Spending on the major health programs rose at a rapid clip, in part because the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) temporarily increased grants to the states under the Medicaid program and boosted payments to some Medicare providers. In addition, as noted, net interest payments, which had plummeted between 1997 and 2003, flattened out. Real federal expenditures for consumption and gross investment—the part of government spending that is a component of real GDP—rose at an annual rate of 8½ percent in the first calendar quarter of 2004; that increase reflected a surge in real defense spending, which now stands more than 30 percent above the levels that prevailed, on average, from 1997 to 2000.

Federal receipts in the twelve months ending in June were 1½ percent higher than during the comparable period of the previous year after having fallen

Change in real government expenditures on consumption and investment

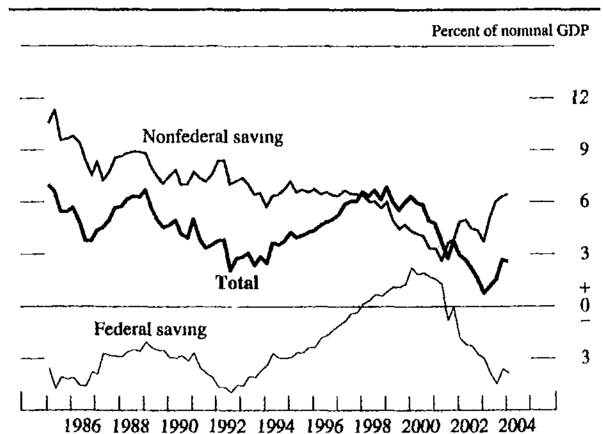


Federal receipts and expenditures



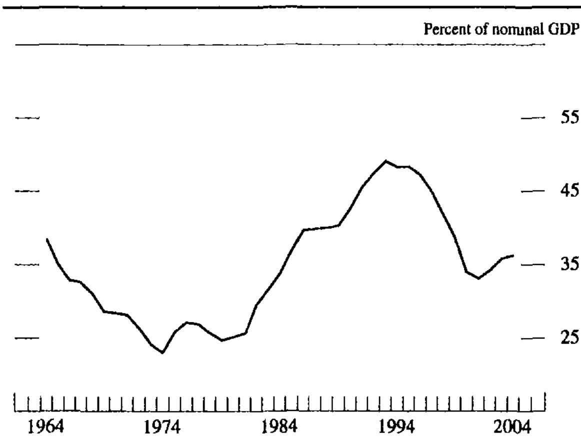
NOTE The budget data are from the unified budget, through 2003 they are for fiscal years (October through September), and GDP is for Q4 to Q3 For 2004, the budget data are for the twelve months ending in June, and GDP is for 2003 Q4 to 2004 Q1

Net saving



NOTE The data are quarterly and extend through 2004 Q1 Nonfederal saving is the sum of personal and net business saving and the net saving of state and local governments

Federal government debt held by the public



NOTE Through 2003, the data for debt are year-end figures, and the corresponding value for GDP is for Q4 at an annual rate, the final observation is for 2004 Q1 Excludes securities held as investments of federal government accounts

markedly between fiscal 2000 and fiscal 2003 Receipts received a substantial boost over the past year from a strong gain in corporate taxes, which were lifted by robust profits. Social insurance taxes, which tend to move in line with wages and salaries, also increased But individual income taxes were below last year's level· Although taxable incomes rose moderately, collections were reduced by the lower withholding rates in place since mid-2003 and by the effects of JGTRRA on refunds and final settlements this spring.

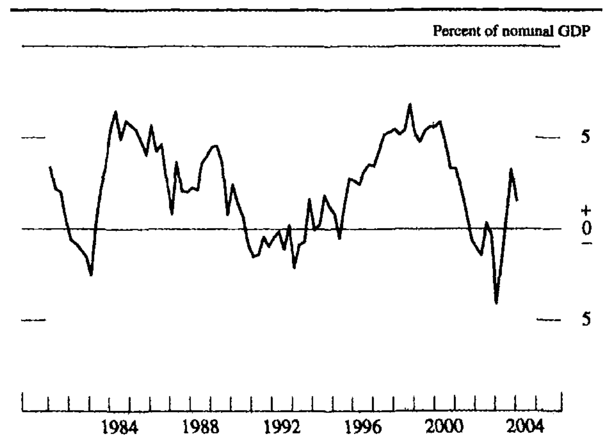
The deterioration in the unified budget since 2000 has been mirrored in a sharp downswing in federal saving—essentially, the unified surplus or deficit adjusted to conform to the accounting practices followed in the national income and product accounts (NIPA) Gross federal saving fell from a high of nearly 3 percent of nominal GDP in 2000 to negative 3 percent of GDP in the first quarter of 2004; measured net of estimated depreciation, federal saving fell from 2 percent of GDP to negative 4 percent of GDP over this period. In the past couple of years, the rise in business saving from the rebound in profits and reductions in corporate taxes has cushioned to some extent the effect of growing budget deficits on national saving. In fact, because of the dramatic increase in business saving in recent quarters, national saving has recovered some from the extreme lows of early 2003. Even so, as of the first quarter of 2004, national saving (measured net of estimated depreciation) was still equal to just about 2½ percent of GDP, compared with a recent high of 6½ percent in 1998. If not reversed over the longer haul, such low levels of national saving could eventually impinge on private capital formation and thus slow the rise of living standards

Reflecting the need to finance the sizable federal budget deficit, federal debt held by the public expanded at an annual rate of 11¾ percent in the first half of the year The ratio of this debt to nominal GDP now exceeds 36 percent. The Treasury tilted its issuance toward longer-term and inflation-indexed securities somewhat, and announced semiannual issuance of a twenty-year inflation-protected bond beginning in July and a five-year inflation-protected note beginning in October.

State and Local Governments

States and localities have started to see some improvement in their budget positions after having gone through several difficult years Strong growth in household income and consumer spending has boosted revenues in recent quarters, as have the additional federal grants authorized under JGTRRA. And although rising medical costs and security needs have continued to put upward pressure on spending, state and local governments have generally held the line on hiring and have kept other outlays in check. The restraint on spending, in combination with a drawdown of reserve funds and some increases in taxes, has helped states and localities satisfy their balanced-budget requirements In fact, between the third quarter of 2003 and the first quarter of 2004, NIPA net saving (excluding social insurance funds) for this sector averaged $21 billion at an annual rate (¼ percent of nominal GDP), compared with negative

State and local government net saving



NOTE The data, which are quarterly, are on a national income and product account basis and extend through 2004 Q1 Net saving excludes social insurance funds

$7 billion in 2002 and negative $31 billion in the first half of 2003 (Net saving is roughly similar to the surplus or deficit in an operating budget) Although a few states are still struggling with strained fiscal situations, most have entered fiscal 2005 (which started on July 1 in all but four states) with expectations of respectable growth in revenues and with budgets in place that allow for some increases in spending on high-priority services and some rebuilding of reserve funds

Real consumption and investment spending by state and local governments was essentially flat in the first quarter of 2004; available indicators point to a moderate increase in the second quarter Outlays for consumption items, which were little changed in 2003, appear to have remained subdued throughout the first half of the year Investment expenditures also were about unchanged in the first quarter, but they turned up sharply in the spring, mainly because of a jump in spending on highways.

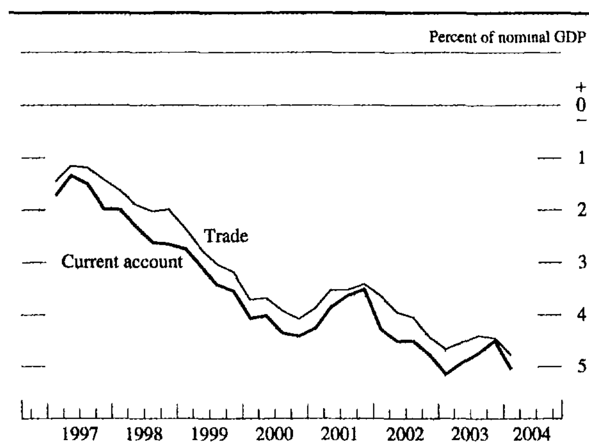
Significant demand for infrastructure spending and favorable interest rates led to robust issuance of state and local government debt to finance capital expenditures and to advance refund higher-cost debt. Nevertheless, over the first half of the year, net issuance edged down from its rapid pace in 2003 to about a 6 percent annual rate The deceleration reflected a decline in short-term borrowing as improvements in the fiscal positions of state and local governments lessened the need for temporary funding of budget shortfalls.

The credit quality of municipal borrowers has stabilized after two years of deterioration, for the year to date, upgrades and downgrades of credit ratings have been roughly equal In a marked change from last year's sentiment, rating agencies have begun to express guarded optimism about the credit quality of states because of improvements in state revenue flows and restraint on spending

The External Sector

In the first quarter of 2004, the U.S. current account deficit expanded to an annual rate of $580 billion, or about 5 percent of GDP As in the past, the widening was driven primarily by a larger deficit in trade of goods and services. The surplus on net investment income declined in the first quarter but remained well above its average value in the previous year The deficit on net unilateral transfers rose because of a concentration of disbursements of government grants in the first quarter.

U S. trade and current account balances



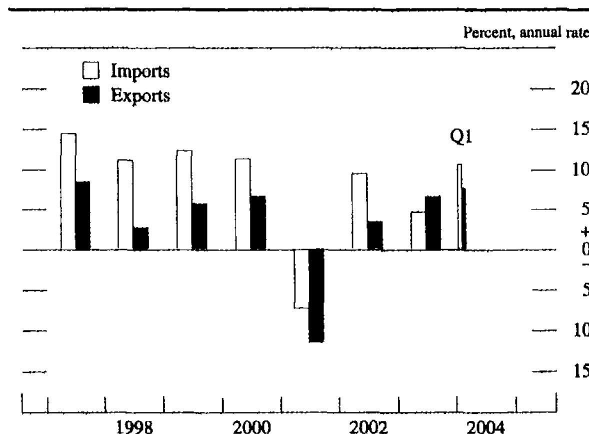
NOTE The data are quarterly and extend through 2004 Q1
SOURCE Department of Commerce

International Trade

The U.S trade deficit in goods and services registered $548 billion at an annual rate in the first quarter, about $46 billion larger than in the fourth quarter of 2003. On average, data for April and May suggest that the trade deficit continued to widen in the second quarter

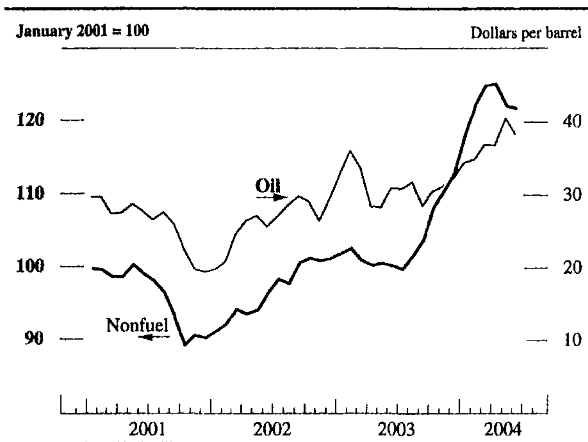
Real exports of goods and services increased at an annual rate of 7½ percent in the first quarter of 2004, well off the blistering 20 percent pace of the fourth quarter but still above the average for 2003. Solid gains in exports since mid-2003 arose in part from the strong economic performance of many of our major trading partners In addition, the net decline in the exchange value of the dollar since 2002 continued to make U.S. goods and services more competitive abroad Increases in exports of U.S. goods were wide-

Change in real imports and exports of goods and services



SOURCE Department of Commerce

Prices of oil and of nonfuel commodities

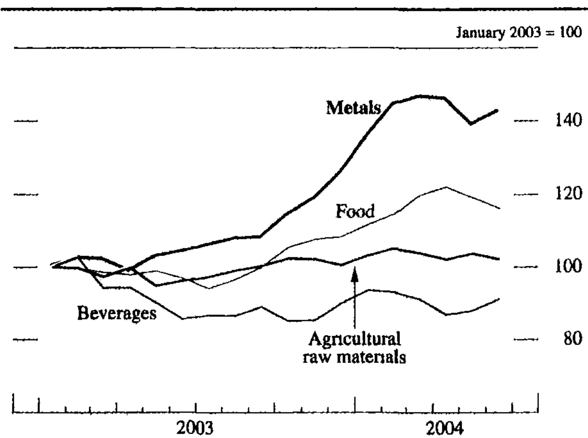


NOTE The data are monthly and extend through June 2004 The oil price is the spot price of West Texas intermediate crude oil The price of nonfuel commodities is an index of forty-five primary-commodity prices from the International Monetary Fund

spread across our major trading partners, with the exception of Japan, and were concentrated in real exports of capital goods, industrial supplies, and consumer goods. Real exports of agricultural products fell sharply, hurt by foreign bans on U.S. beef products following reports of mad cow disease in a U S. herd Exports of services rose moderately.

Prices of total exports rose at an annual rate of 5¾ percent in the first quarter, boosted by another jump in agricultural prices along with substantial increases in the prices of other primary commodities and industrial supplies. Prices of U S. agricultural exports have been pushed up by very strong global demand, particularly from China For specific products, such as cotton and soybeans, lower production in some countries also contributed to price run-ups. More recently, prices of soybeans and other agricultural products have eased in the face of a slowing in the growth of demand from China and the anticipation of larger harvests Even so, available data point to continued strong increases in export prices in the second quarter

Prices of major nonfuel commodities



NOTE The data are monthly and extend through June 2004 The metals category includes aluminum, copper, and iron ore, food includes cereals, vegetable oils and protein meals, seafood, and meat, agricultural raw materials consists of timber, cotton, wool, rubber, and hides, beverages consists of coffee, cocoa beans, and tea

SOURCE International Monetary Fund

Supported by solid U.S. economic growth, real imports of goods and services rose at an annual rate of 10½ percent in the first quarter. This increase was below the fourth-quarter pace but still roughly double the rate of increase for 2003 as a whole Real imports of goods were boosted by a sharp increase in oil imports Gains in imports of non-oil goods were also sizable and widespread across categories Imports of services grew slightly in the first quarter

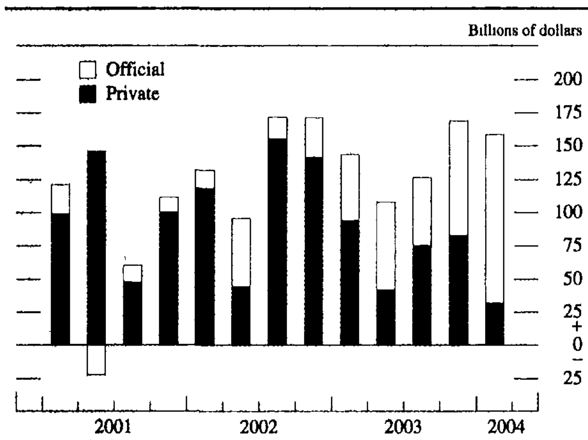
The spot price of West Texas intermediate (WTI) crude oil surged above $40 per barrel in May and has since fluctuated close to that level The run-up in the price since the beginning of the year has been driven by surprisingly strong global demand for oil. Supply issues have been important as well These were mainly continued violence in Iraq, including the sabotage of oil facilities, attacks on foreigners in Saudi Arabia, ongoing unrest in Nigeria, political turmoil in Venezuela, and tax payment difficulties at a major Russian oil company. The recent increase in OPEC production (mainly by Saudi Arabia) has eased the upward pressure on prices a bit, but they have remained elevated

Prices of imported non-oil goods rose at an annual rate of 5½ percent in the first quarter after minimal increases in the second half of 2003 Prices for imported consumer goods rose at an annual rate of 2¾ percent after being flat in 2003. Skyrocketing global commodity prices last year and early this year boosted prices of imported industrial supplies (especially metals) and of foods, feed, and beverages The jump in commodity prices reflected strong demand, the net depreciation of the dollar over the past two years, and the limited expansion in supply of many commodities since the 2001 trough in commodity prices. Available data suggest a modest stepdown in the rate of increase of import prices in the second quarter; the move in part reflects a flattening of consumer goods prices

The Financial Account

The U.S current account deficit has continued to be financed largely by foreign flows into U S bonds Foreign official inflows, already sizable in 2003, rose

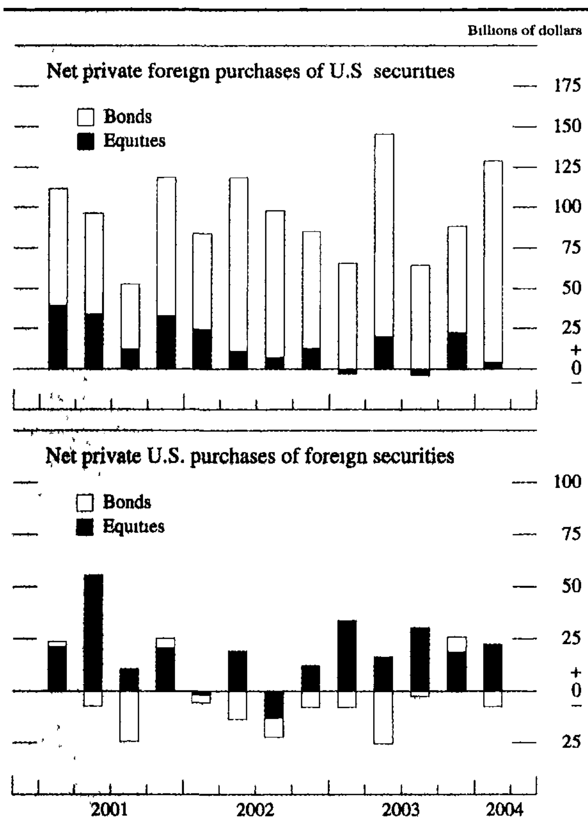
U S net financial inflows



SOURCE Department of Commerce

sharply in the first quarter of 2004 and then moderated somewhat Similarly, private foreign purchases of U.S bonds, which were significant in 2003, increased sharply in the first quarter and also appear to have moderated in the second quarter In contrast, foreign demand for U.S equities was weak in 2003 and has remained so in 2004 Purchases of foreign

U S net international securities transactions



SOURCE Department of Commerce and the Federal Reserve Board

equities by private U S investors appear to be strengthening, but U.S investors still show no appetite for foreign bonds.

Direct investment into the United States in the first quarter continued to be restrained by the slowdown of global mergers and acquisitions since 2002. In contrast, U.S. direct investment abroad was strong in 2003 and in the first quarter of 2004, as the effect of fewer mergers and acquisitions was offset by sizable reinvested earnings.

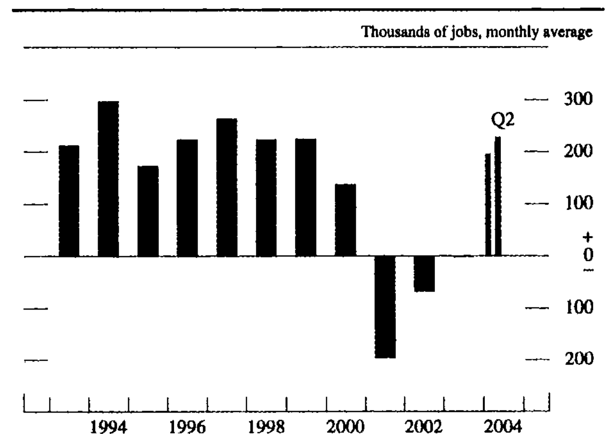
The Labor Market

Employment and Unemployment

The demand for labor turned up in late 2003 after an extended period of weakness, and it has gathered additional steam this year After averaging about 60,000 per month in the fourth quarter of 2003, gains in private nonfarm payroll employment rose to an average of about 200,000 per month in the first half of 2004. The job gains were especially large in March, April, and May but ebbed somewhat in June The civilian unemployment rate, which had fallen from a recent peak of 6 3 percent in June 2003 to 5.7 percent in December 2003, was little changed over the first half of the year. In June, it stood at 5.6 percent.

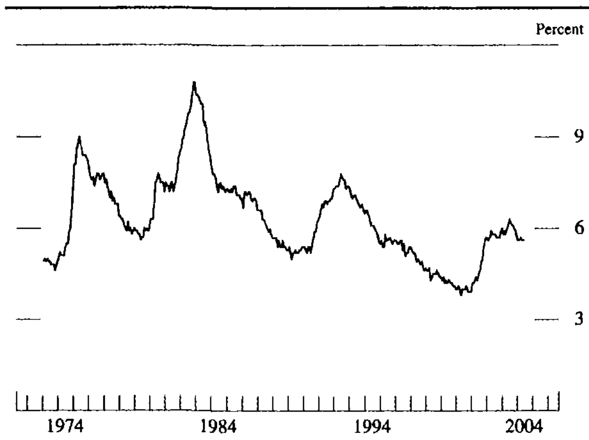
The increases in payrolls over the first half of 2004 were widespread. Especially notable was the turnaround in the manufacturing sector, in which employment bottomed out in January and then rose a cumulative 65,000 jobs through June. The rise in manufacturing jobs was concentrated in the durable goods industries—in particular, those making fabricated metals and other construction-related products,

Net change in payroll employment



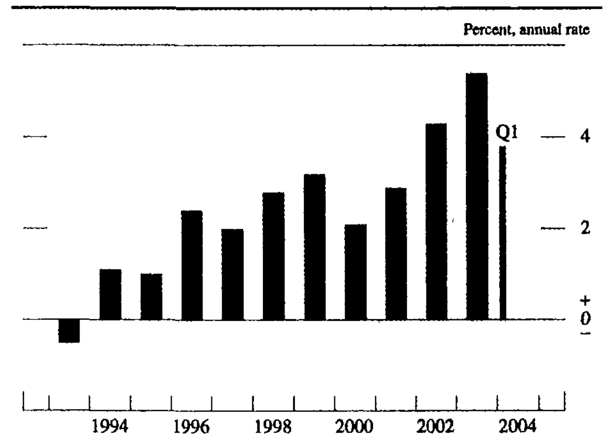
NOTE Private nonfarm

Civilian unemployment rate



NOTE The data are monthly and extend through June 2004

Change in output per hour



NOTE Nonfarm business sector

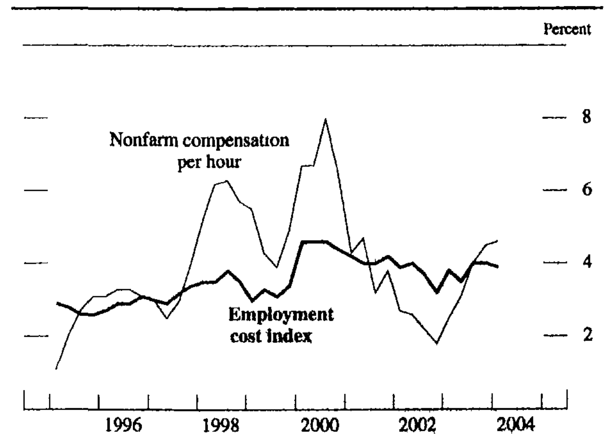
computers and electronic equipment, and machinery. After a long string of declines, employment at producers of nondurable goods was little changed, on net, over the first half. Job gains in virtually all other major sectors have been greater this year than last. In particular, hiring in retail trade, which had been lackluster in 2003, turned up appreciably, and construction employment increased further. The professional and business services sector also posted a sizable rise, in part because the rebound in manufacturing activity lifted hiring at temporary-help firms. A clear indication of the breadth of the employment increases is provided by the six-month diffusion index compiled by the Bureau of Labor Statistics (BLS). The index is equal to the percentage of industries that increased employment over the most recent six months plus one-half the percentage with unchanged employment; in June, the index moved up to its highest level since April 2000

Productivity and Labor Costs

Gains in labor productivity have slowed somewhat in recent quarters after the spectacular increases of mid-2003. Still, according to the currently published data, output per hour in the nonfarm business sector rose a remarkable 5½ percent over the year ending in the first quarter. Over the past three years, increases in productivity have averaged more than 4 percent per year, compared with average increases of about 2½ percent per year in the second half of the 1990s. During that earlier period, an expansion of the capital stock was an important source of productivity growth. However, in the more recent period, when the business environment—at least until the past few quarters—was characterized by sluggish demand, lean capital budgets, and an extraordinary reluctance of firms to add to payrolls, businesses appear to have raised their productivity mainly through changes in organizational structures and better use of the capital already in place With hiring having picked up of late, measured productivity growth may slow in coming quarters; but if recent experience is any guide, businesses will continue to focus on achieving structural improvements in the efficiency of their operations. The upswing in investment spending now under way also bodes well for sustained favorable productivity performance in the period ahead.

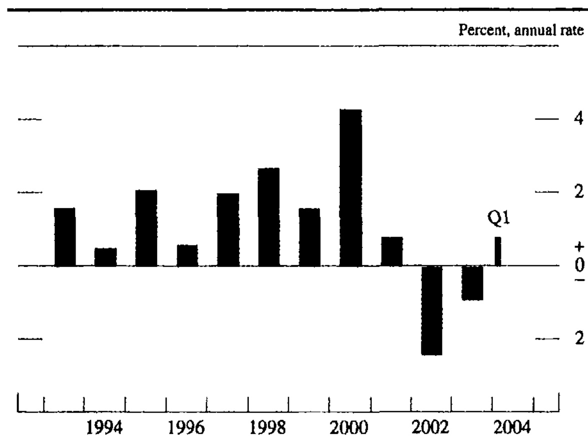
The rapid productivity growth in recent years has helped to bolster increases in hourly compensation in the face of the soft labor market and the low consumer price inflation in 2003. As a result, increases in the employment cost index (ECI) mea-

Measures of change in hourly compensation



NOTE The data extend through 2004 Q1 For nonfarm compensation, *change is over four quarters, for the employment cost index (ECI), change is* over the twelve months ending in the last month of each quarter Nonfarm compensation is for the nonfarm business sector, the ECI is for private industry excluding farm and household workers

Change in unit labor costs



NOTE Nonfarm business sector

sure of hourly compensation, which is based on a survey of private nonfarm businesses conducted quarterly by the BLS, have held fairly steady of late. In fact, the rise in the ECI over the twelve months ending in March—at a shade less than 4 percent—was virtually the same as the increases over the preceding two years Benefit costs, which rose 7 percent over the year ending in March, have continued to be the fastest rising portion of hourly compensation; health insurance costs have remained on a steep uptrend, and employers have boosted their contributions to defined-benefit retirement plans to make up for earlier stock market losses. The rising benefit costs have likely exerted some downward pressure on wages, which rose just 2½ percent over the twelve months ending in March; the twelve-month change in the wage component of the ECI, which was close to 4 percent in 2000 and 2001, has been in the range of 2½ percent to 3 percent since late 2002.

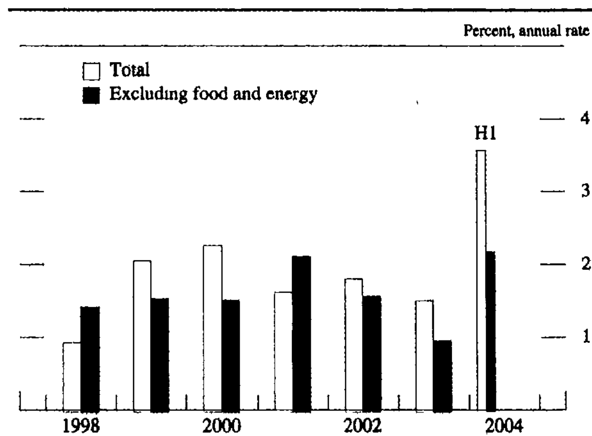
The change in compensation per hour in the nonfarm business (NFB) sector—an alternative measure of hourly compensation based on data constructed for the NIPA—has swung widely in recent years Fluctuations in the value of stock option exercises, which are excluded from the ECI but included in the NFB measure, likely account for some of the differential movements in the two series The four-quarter change in the NFB measure bottomed out at a bit less than 2 percent in 2002, when the value of exercised options was dropping; it has moved up steadily since that time and, in the first quarter, stood at 4½ percent—a rate not much different from the increase in the ECI. With productivity growth slowing to a pace below that of NFB hourly compensation, unit labor costs rose in both the fourth and first quarters after having trended down over the preceding two years.

Prices

Inflation moved higher in the first half of 2004 After rising just 1½ percent over the four quarters of 2003, the price index for personal consumption expenditures (PCE) increased at an annual rate of 3½ percent between the fourth quarter of 2003 and May 2004 In that period, energy prices soared, and increases in core consumer prices picked up to an annual rate of 2¼ percent—more than 1 percentage point faster than the increase in 2003. Data for the consumer price index (CPI) are available through June and show some moderation in the core component of the series Over the first half of the year, the core CPI rose at an annual rate of 2½ percent, compared with an increase of 1¼ percent over the four quarters of 2003

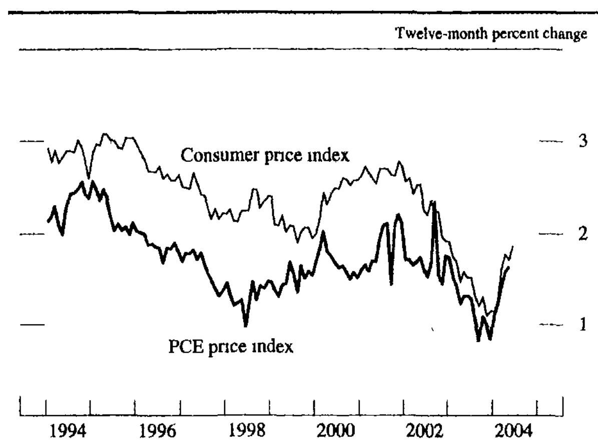
Reflecting the surge in crude oil prices, PCE energy prices rose at an annual rate of more than 25 percent in the first quarter; they apparently posted another outsized increase in the second quarter. Gasoline prices increased rapidly through May as crude oil costs rose and as price markups were boosted by strong demand and lean inventories; although gasoline prices have fallen on balance since late May, they are currently nearly 30 percent above their level at the end of last year. As for natural gas, which can often substitute for fuel oil in the industrial sector, spot prices were elevated at the start of the year, fell somewhat in February and March, and trended up over the spring. The higher spot prices for natural gas this spring pushed up prices paid by consumers through June. PCE electricity prices appear to have risen at an annual rate of 3 percent over the first half of the year, a pace similar to that in 2003.

Change in PCE price index



NOTE The data are for personal consumption expenditures (PCE) The changes for 2004 are from 2003 Q4 to May 2004

Change in consumer prices excluding food and energy



NOTE The data for the CPI extend through June 2004, for PCE, they extend through May 2004

Although volatile from month to month, consumer food prices rose moderately on balance over the first half of 2004 after having moved up in late 2003. Robust global demand is imparting upward impetus to food prices, but U.S. producers are in the process of boosting supply, which should help restrain increases in retail food prices in coming quarters.

The step-up in core PCE inflation this year has been especially pronounced in a few categories In particular, prices of motor vehicles have firmed after a noticeable decrease in 2003. In addition, increases in shelter costs, which were surprisingly low in 2003, are now running more in line with earlier trends Core inflation has also been lifted this year by substantial increases, on balance, in a number of categories for which prices cannot be derived from market transactions and thus must be imputed by the Bureau of Economic Analysis—for example, prices of financial services provided by banks without explicit charge These non-market-based prices, which were about flat in 2003, are difficult to estimate, and the imputed figures tend to be volatile

A number of factors have contributed to the run-up in core inflation this year. Higher oil prices have doubtless raised the cost of producing other goods and services. So have the steep increases in prices of non-oil commodities such as copper and lumber, which came about as economic activity strengthened worldwide and as industrial capacity utilization both here and abroad tightened. Likewise, the decline in the dollar has boosted non-oil import prices and thus the costs of inputs for many domestic producers The weaker dollar has also likely lessened the pressure on firms facing foreign competition to hold the line on prices—a consideration that is probably contributing to the widespread perception that firms' pricing power has increased lately. Moreover, unit labor costs have edged up recently after having declined noticeably in 2002 and 2003

From a cyclical perspective, the sharp upturn in commodity prices is not surprising, given the pickup in the growth of industrial production. In fact, such large increases in commodity prices are typical as economic activity accelerates and capacity utilization rises—especially for products for which the supply is relatively fixed in the short run Some portion of these increases usually proves transitory. More important, cyclical swings in commodity prices tend to have only a minor effect on overall inflation, both because they account for a small share of total costs and because changes in commodity prices tend to be partly absorbed in firms' profit margins, at least for a time

The faster rate of inflation this year underscores the difficulty of gauging price pressures. Nevertheless, on the whole, the evidence suggests that slack remains in labor and product markets, which should be exerting some downward pressure on inflation. The unemployment rate—at 5½ percent currently—is not significantly lower than it was through much of 2002 and 2003, when core inflation was trending down. And despite the run-up this year, capacity utilization in the manufacturing sector is still below its longer-run average In addition, the strong upward trend in productivity is continuing to help keep the rise in labor costs muted, and profit margins are sufficiently wide to give firms scope to absorb cost increases for a while without putting undue upward pressure on prices.

The upturn in actual inflation has been echoed in some measures of inflation expectations For example, according to the Michigan Survey Research Center, the median expectation for inflation over the coming year has averaged slightly more than 3 percent since early spring after hovering in the area of 2¼ percent to 2¾ percent in 2003 and early 2004. The median expectation for inflation over the next five to ten years has been running a bit below 3 percent in recent months, a reading similar to the figures for 2002 and 2003. According to the Survey of Professional Forecasters conducted by the Federal Reserve Bank of Philadelphia, expectations of inflation over the next ten years held steady in June at 2½ percent. Inflation compensation over the next five years as measured by the spread between the yield on nominal Treasury securities and their indexed counterparts rose noticeably during the first half of 2004. To be sure, inflation compensation is also influenced by perceptions of inflation risk and the secular increase in demand for inflation-indexed debt, but

Alternative measures of price change
Percent

Price measure	2002 to 2003	2003 to 2004
Chain-type (Q1 to Q1)		
Gross domestic product	1 7	1 8
Gross domestic purchases	2 3	1 7
Personal consumption expenditures	2 4	1 6
Excluding food and energy	1 6	1 3
Fixed-weight (Q2 to Q2)		
Consumer price index	2 2	2 8
Excluding food and energy	1 5	1 8

NOTE Changes are based on quarterly averages of seasonally adjusted data

the rise in near-term inflation compensation likely reflects, at least in part, higher inflation expectations. Similar to the survey-based measures of longer-run inflation expectations, inflation compensation for the period five years to ten years ahead was little changed on net over the first half of the year.

Broader NIPA price measures are available only through the first quarter, and the four-quarter changes in these series do not show the rise in inflation indicated by the monthly data discussed above In particular, the rate of increase in the price index for GDP over the year ending in the first quarter was just 1¾ percent, the same as over the preceding year The four-quarter change in the price index for gross domestic purchases—which is defined as the prices paid for purchases of domestic and imported consumption, investment, and government goods and services—dropped from 2¼ percent to 1¾ percent over the same period, the deceleration reflects mainly the effects of energy prices, which rose even more rapidly over the year ending in the first quarter of 2003 than they did over the most recent year

U.S. Financial Markets

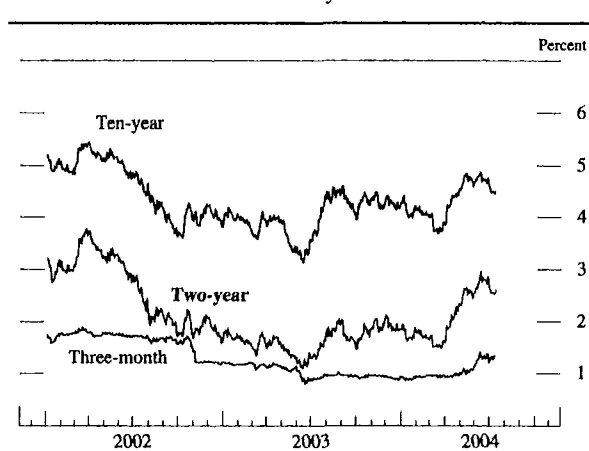
As 2004 opened, financial market conditions were quite accommodative, with low corporate bond yields, narrow risk spreads, and relatively easy terms and standards on bank lending Although equity prices changed little, and interest rates rose on balance in response to positive economic news and expectations of a tightening of monetary policy, financial conditions in the first half of the year remained supportive of economic growth Business borrowing nevertheless remained tentative, while increases in the debt of the federal government and of households were sizable.

Interest Rates

From the end of 2003 through the end of March, yields on nominal Treasury coupon securities fell, on net, about 30 to 45 basis points. Although interest rates rose immediately after the FOMC's January meeting in response to the Committee's decision to remove its statement that monetary policy could remain accommodative for "a considerable period," the increase proved to be short lived Weak employment reports released in early February and early March prompted yields to fall amid doubts about the strength of the economic expansion. Federal funds futures contracts at the end of March appeared to indicate that market participants placed small odds on a tightening of monetary policy before late 2004, and contracts also seemed to price in only a gradual increase in the federal funds rate during 2005.

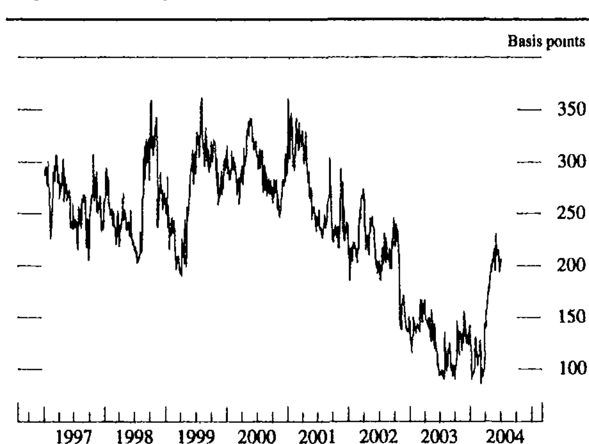
Interest rates backed up in the second quarter as data releases increasingly suggested that the eco-

Interest rates on selected Treasury securities



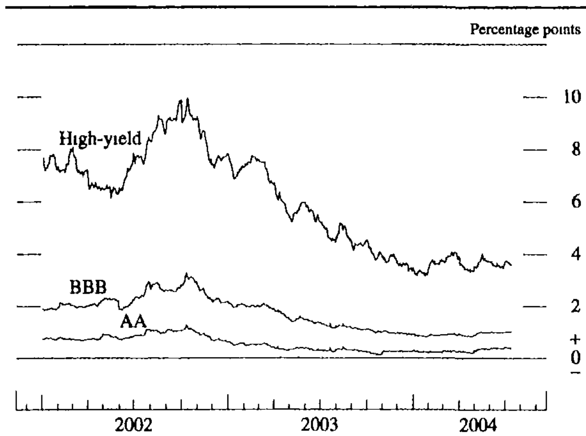
NOTE The data are daily and extend through July 14, 2004

Implied volatility of short-term interest rates



NOTE The data are daily and extend through July 14, 2004 The series shown is the implied volatility of the three-month Eurodollar rate over the coming four months, as calculated from option prices

Spreads of corporate bond yields over the ten-year Treasury yield



NOTE The data are daily and extend through July 14, 2004 The spreads compare the yields on the Merrill Lynch AA, BBB, and 175 high-yield indexes with the yield on the ten-year off-the-run Treasury note

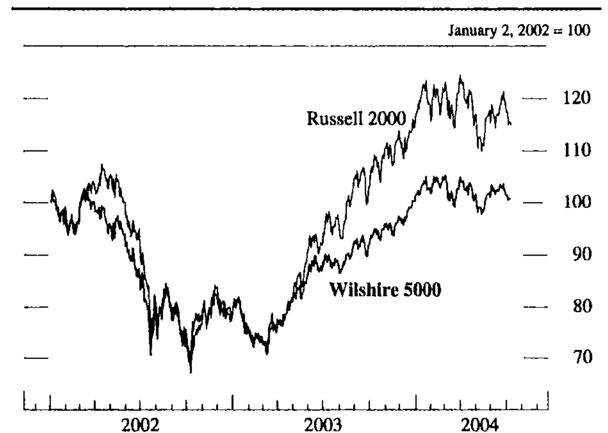
nomic expansion would remain vigorous. Yields on the two-year and ten-year nominal Treasury notes ended the first half of the year 90 and 36 basis points higher, respectively, than at the end of 2003, as markets adjusted to the greater likelihood of an earlier onset and more rapid pace of monetary policy tightening. The surprisingly strong employment reports published in April and May, higher-than-expected readings on core inflation, and surging oil prices all spurred increases in Treasury yields. After the release of the employment report in May, federal funds futures contracts priced in a hike in the target federal funds rate at the June FOMC meeting and a more rapid tightening of monetary policy than had been anticipated With the evolving outlook for monetary policy, the volatility of short-term interest rates implied by option prices jumped in the first half of the year after staying in a relatively low range in 2003 Near-term interest rates declined a bit after the Committee's decision at its June meeting to raise the intended federal funds rate 25 basis points, the Committee's reaffirmation that policy accommodation likely could be removed at a "measured" pace apparently reassured investors that a steep rise in the federal funds rate probably was not in train.

Yields on investment-grade corporate debt moved roughly in line with those on comparable nominal Treasury securities over the first half of the year, producing little net change in risk spreads from their level at the end of last year Spreads on speculative-grade debt over Treasury debt declined a bit further after having narrowed sharply during 2003 as the economic expansion was seen as gathering steam.

Equity Markets

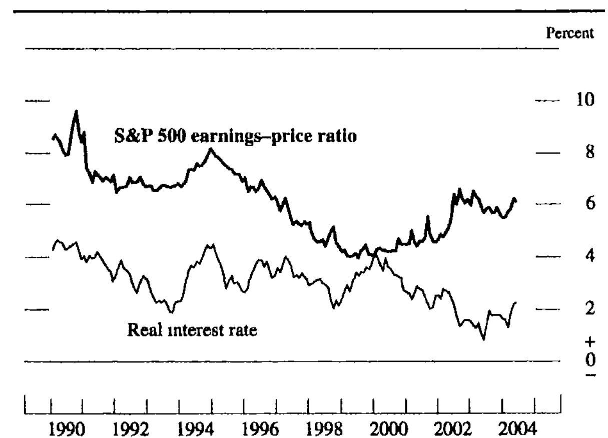
Over the first half of 2004, equity prices were subject to the strong crosscurrents of robust earnings reports, rising interest rates, fluctuating fears about geopolitical developments, and sharply higher oil prices On balance, broad equity price indexes at the end of June had edged about 2½ percent to 3¼ percent above year-end levels after having surged 25–30 percent over the course of 2003. Over the first half, analysts raised their estimates of profits for coming quarters; the upward revision outstripped the more modest increase in equity prices and boosted the ratio of expected year-ahead earnings to stock prices With real interest rates higher, however, the difference between the earnings–price ratio and the real ten-year

Major stock price indexes



NOTE The data are daily and extend through July 14, 2004

S&P 500 forward earnings–price ratio and the real interest rate



NOTE The data are monthly and extend through June 2004 The forward earnings–price ratio is based on I/B/E/S consensus estimates of earnings over the coming year The real interest rate is estimated as the difference between the ten-year Treasury rate and the expected ten-year inflation rate reported in the survey by the Federal Reserve Bank of Philadelphia

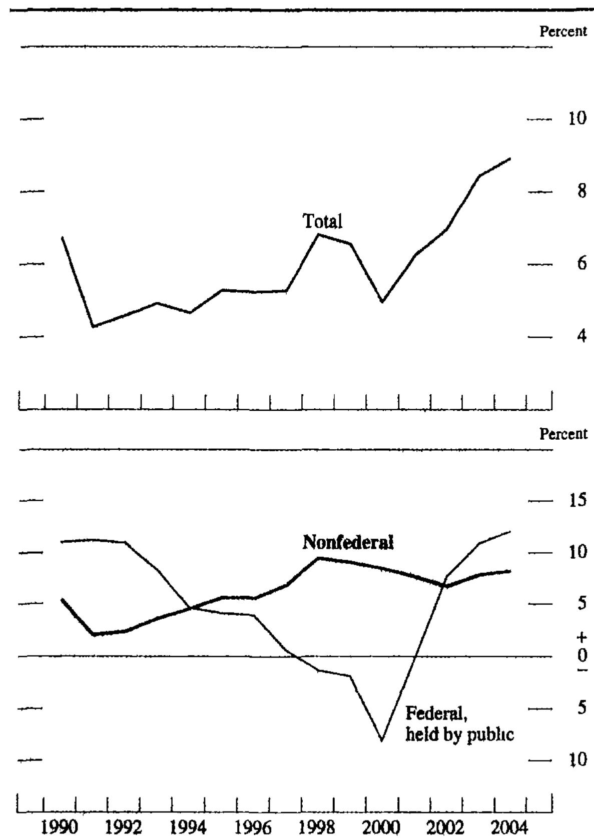
Treasury yield—a crude measure of the equity risk premium—changed little to remain close to its average value over the past two decades and above its level during the late 1990s.

Debt and Financial Intermediation

Aggregate debt of the domestic nonfinancial sectors expanded at an annual rate of about 8½ percent in the first quarter of 2004, a gain similar to last year's increase Debt growth in the business sector has remained subdued so far this year, as ample internal funding has limited the need for external finance. In contrast, household debt has continued to expand rapidly, spurred by an elevated pace of home purchases and cash-outs from mortgage refinancing. The large federal budget deficit led to another sharp increase in Treasury debt in the first half of this year. Municipal borrowing moderated somewhat, on balance, in the first half of the year, as the improving fiscal condition of state and local governments reduced the need for short-term borrowing to cover budget gaps.

The growth of credit on the books of depository institutions picked up to an annual rate of 14 percent in the first quarter of 2004. Financing secured by residential real estate—including home mortgages, home equity loans, and mortgage-backed securities—drove the expansion. In contrast, business loans continued to run off, falling at an annual rate of about 5 percent in the first half of the year after a 10 percent drop in 2003. The deceleration was consistent with some signs that demand for business loans was beginning to recover as well as with an easing of standards and terms on these loans.

Change in domestic nonfinancial debt

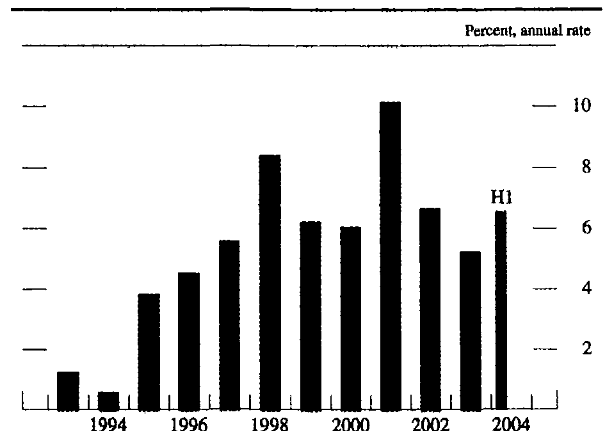


NOTE For 2004, change is from 2003 Q4 to 2004 Q1 at an annual rate For earlier years, the data are annual and are computed by dividing the annual flow for a given year by the level at the end of the preceding year The total consists of nonfederal debt and federal debt held by the public Nonfederal debt consists of the outstanding credit market debt of state and local governments, households, nonprofit organizations, and nonfinancial businesses Federal debt held by the public excludes securities held as investments of federal government accounts

The M2 Monetary Aggregates

In the first half of 2004, short-term interest rates were stable and M2 grew at an annual rate of 6½ percent—a pace that was roughly in line with estimates of nominal GDP—after contracting at a record rate in the fourth quarter of 2003 Liquid deposits—the largest component of M2—had been depressed late last year by the ebbing of last summer's mortgage refinancing boom. Mortgage refinancings tend to boost M2 as the proceeds are temporarily placed in non-interest-bearing deposit accounts pending disbursement of funds to the holders of mortgage-backed securities When refinancings slowed last year, the decline in such escrow accounts held down the growth of liquid deposits. In the first half of this year, M2 probably received a boost from the new round of

M2 growth rate



NOTE M2 consists of currency, travelers checks, demand deposits, other checkable deposits, savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds

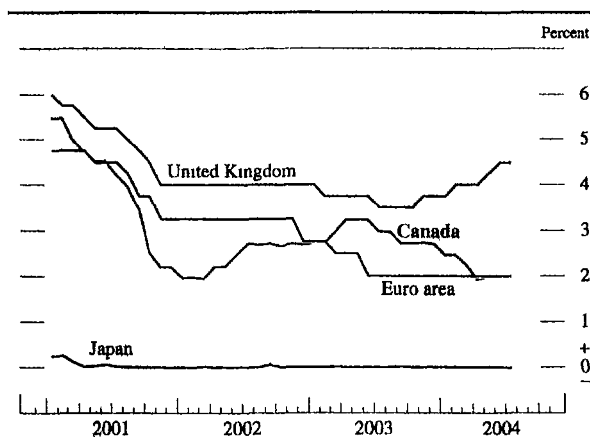
mortgage refinancings that followed the first-quarter decline in mortgage interest rates The strength in liquid deposits was partly offset, however, by continued weakness in money market mutual funds and small time deposits Given the recent very low yields on these two components of M2, households likely viewed them as less attractive savings vehicles than other assets

International Developments

Foreign economic activity expanded in the first half of this year at a pace only slightly below the rapid increase in the second half of 2003 Global trade has been boosted by strong demand, especially from the United States and China The run-up in oil and commodity prices has contributed to rising, though still moderate, inflation across the industrial and developing countries.

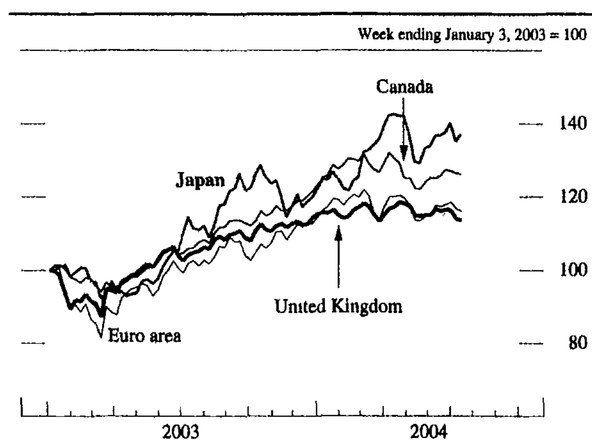
By the end of the first half of this year, monetary policy in most major foreign economies had either tightened or assumed a less accommodative tone Citing high rates of capacity utilization and mounting inflationary pressures, the Bank of England has raised its target rate 100 basis points since early November Mexico and China also have tightened policy. Elsewhere, including the euro area, Canada, and Japan, central banks most recently have kept policy unchanged after easing previously. In general, official statements are expressing increasing concern over the inflationary risks associated with stronger economic activity and higher world energy and commodity prices.

Official interest rates in selected foreign industrial countries



NOTE The data are as of month-end, the last observation for each series is the average of trading days through July 14, 2004 The data shown are the call money rate for Japan, the overnight rate for Canada, the refinancing rate for the euro area, and the repurchase rate for the United Kingdom

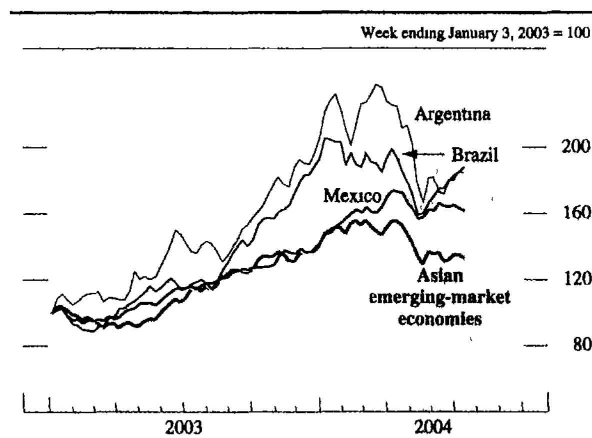
Equity indexes in selected foreign industrial countries



NOTE The data are weekly The last observation for each series is the average of trading days through July 14, 2004

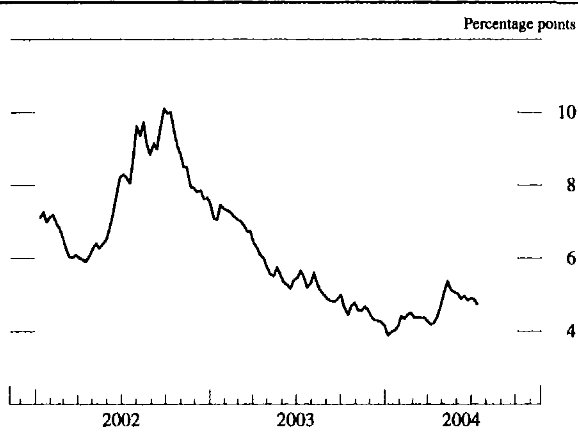
In foreign financial markets, equity price performance has been more mixed so far in 2004 than during the second half of 2003; sharply rising interest rates over the past few months have weighed on equity valuations, damping the effects of an improved earnings outlook. Since year-end, stock prices in Europe and Canada have changed little, on balance In contrast, rapidly improving economic conditions in Japan have helped boost Japanese equity prices about 10 percent Other Asian stock price indexes have fallen, on average, in part because of concerns about the possibility of an acute slowdown in China Mexican stocks have been bolstered by strong earnings growth of leading Mexican communications firms and, more generally, by the strengthening U.S

Equity indexes in selected emerging-market economies



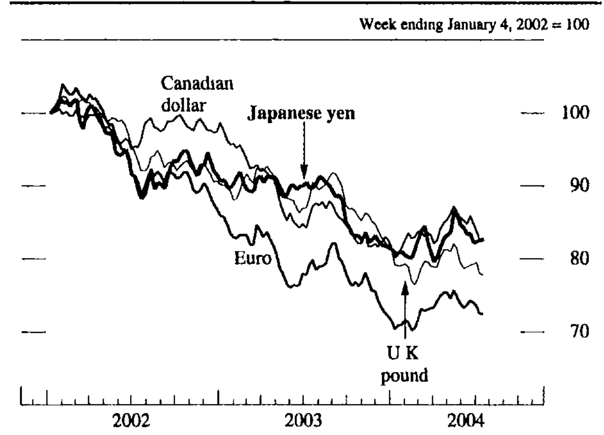
NOTE The data are weekly The last observation for each series is the average of trading days through July 14, 2004 The Asian emerging-market economies are China, Hong Kong, India, Indonesia, Malaysia, Pakistan, the Philippines, Singapore, South Korea, Taiwan, and Thailand, the index weight for each of these economies is its market capitalization as a share of the group's total

Spread on internationally issued sovereign debt of emerging-market economies



NOTE The data are weekly averages The last observation is the average of trading days through July 14, 2004 The series shown is the J P Morgan Emerging Market Bond Index Plus (EMBI+), which is the spread of the yield of certain dollar-denominated sovereign debt instruments of emerging-market economies over U S Treasury securities, over the period shown, the index encompassed nineteen countries

U S dollar exchange rate against selected major currencies

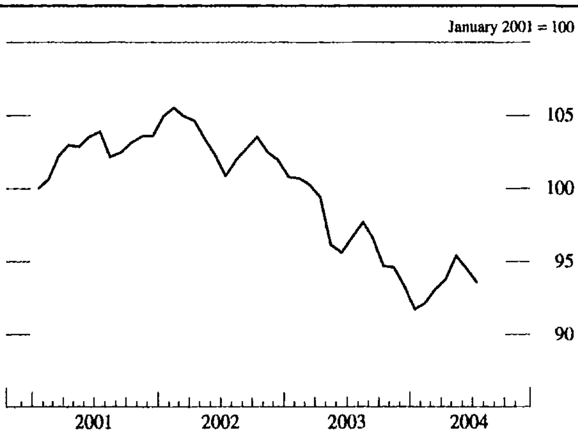


NOTE The data are weekly and are in foreign currency units per dollar The last observation for each series is the average of trading days through July 14, 2004

expansion Foreign long-term interest rates rose rapidly in the second quarter as new data (including from the United States) showing faster growth and higher inflation led market participants to expect more-aggressive monetary tightening. Over the first half of the year, the spread on internationally issued sovereign debt of emerging-market economies over U.S. Treasuries moved up somewhat from its very low level

After depreciating over the previous two years, the value of the dollar rose slightly, on balance, in the first half of 2004. The firming of the dollar has been attributed to perceptions by market participants that near-term monetary tightening in the United States would be faster than such tightening abroad.

U S dollar nominal exchange rate, broad index



NOTE The data are monthly and are in foreign currency units per dollar The last observation is the average of trading days through July 14, 2004 The broad index is a weighted average of the foreign exchange values of the U S dollar against the currencies of a large group of major U S trading partners The index weights, which change over time, are derived from U S export shares and from U S and foreign import shares

Industrial Economies

A broadly based recovery appears to have been established in Japan over the first half of 2004. Real GDP rose at an annual rate of more than 6 percent in the first quarter after an even greater increase in the fourth quarter Aided by demand from China, growth of Japanese real exports remained robust. Personal consumption and business investment also firmed More-recent indicators show that domestic strength continued in the spring with large gains in household expenditures and improved labor market conditions Deflation continued to wane in Japan. Consumer price deflation over the first half of the year was slight, and wholesale prices increased. In financial markets, the stronger economy boosted equity markets and helped drive up the yield on the ten-year bellwether government bond to more than 1¾ percent from its June 2003 record low of about ½ percent. After making substantial sales of yen for dollars in the first quarter, Japanese authorities ceased intervention in mid-March. Even so, the yen depreciated early in the second quarter before appreciating to around ¥109 per dollar

Economic conditions in the euro area firmed over the first half of 2004, but performance varied across countries, and the region as a whole continues to lag the global upturn. Real GDP in the euro area increased at an annual rate of 2¼ percent in the first quarter; output in France, Spain, and several smaller

member countries rose relatively briskly, while growth in Germany and Italy was less robust. In the first quarter, domestic demand firmed noticeably, except in Germany, where growth was due entirely to a spike in exports. German consumer spending remains anemic, held down by a weak labor market and low consumer confidence. Euro-area indicators for the second quarter initially were upbeat, but more-recent data have been mixed. Labor markets have yet to benefit from the recovery, and the average unemployment rate in the region edged up to 9 percent in the spring. Inflation for the euro area over the twelve months ending in June was near 2½ percent, a rate above the European Central Bank's medium-term goal of less than, but close to, 2 percent. Excluding energy, food, alcohol, and tobacco, prices rose slightly less than 2 percent over the same period.

Economic expansion in the United Kingdom continued unabated over the first half of 2004 Labor markets tightened further; the unemployment rate edged down to its lowest level in almost three decades, and labor earnings posted solid gains. Despite the strong economy, consumer price inflation over the twelve months ending in June was 1½ percent, remaining below the central bank's official target rate of 2 percent. Conditions in the U.K. housing market, however, remained red hot, with double-digit price increases, high levels of household mortgage and consumer borrowing, and sizable withdrawals of home equity.

The Canadian economy picked up steam in the first half of 2004 after a year plagued with difficulties including SARS, mad cow disease, and a regional power outage. Sizable gains in consumption and investment boosted output in the first quarter, and indicators are pointing to continued good performance in these sectors. Export growth was strong, as the robust economic performance of the United States appears to have outweighed the negative effect of Canadian dollar appreciation on trade. The unemployment rate was relatively stable over the first half, and employment bounced back in the second quarter from a first-quarter lull. Consumer price inflation decreased early in the year, but energy costs helped drive up the rate to 2½ percent over the twelve months ending in June. Prices excluding food, energy, and indirect taxes have remained more subdued, rising slightly less than 1½ percent over the same period.

Emerging-Market Economies

Estimates suggest that real GDP in China surged in the first quarter with continued outsized gains in fixed-asset investment. Fears of overinvestment, particularly in the steel, cement, and aluminum industries, led Chinese officials to intensify their tightening measures early in the second quarter. These measures included increases in reserve requirements and in some interest rates as well as stricter criteria for the approval of investment projects. A sharp slowdown in estimated real GDP for the second quarter suggests that these steps are working. Despite the recent slowing in growth, Chinese exports and imports soared in the first half of the year, and trade was close to balanced.

Growth in the other Asian emerging-market economies slowed only moderately in the first quarter from the fast pace at the end of last year. Exports, which continued to be the driving force behind that growth, were fueled by Chinese demand as well as by the recovery in the global high-tech market and stronger world demand overall Consumer demand generally rose across the region with the notable exception of Korea, where high levels of consumer debt are weighing on spending. Although still only moderate, inflation across the Asian emerging-market economies is beginning to rise as stronger aggregate demand takes hold and higher energy and commodity prices pass through to prices more generally.

The Mexican economy has been propelled this year by strong demand from the United States. Gains have been broadly based, with sharp increases in industrial production, exports, construction, and retail sales Employment in the industries most closely linked to U.S. trade also has started to increase Responding to a rise in twelve-month inflation to slightly above its 2 percent to 4 percent target range, the Bank of Mexico has tightened policy several times so far this year. Elevated oil prices boosted the Mexican public-sector fiscal surplus to a record high during the first five months of the year and facilitated an increase in federal transfers to state governments.

In Brazil, GDP grew robustly in the first quarter, and indications are that economic activity continued to expand in the second quarter with support from strong external demand. Job growth has been robust, although unemployment has remained high. Inflation, however, continues to concern authorities Asset prices weakened earlier this year, in part because of rising global interest rates but also because of market participants' unease about the direction of structural and fiscal reforms, since then, asset prices have partially rebounded.

The recovery in Argentina has continued at a rapid pace in recent quarters, but limited investment in the energy sector, reflecting a lack of structural reforms, has forced the government to import electricity, natu-

ral gas, and fuel oil from neighboring countries Creditors have shown little enthusiasm for the country's latest debt restructuring plan, and the federal government faces difficult challenges in normalizing its international financial situation and reforming its fiscal relations with the provinces. □

Summary of Papers Presented at the Conference "Models and Monetary Policy: Research in the Tradition of Dale Henderson, Richard Porter, and Peter Tinsley"

Jon Faust, of the Board's Division of International Finance; Athanasios Orphanides, of the Board's Division of Monetary Affairs; and David L Reifschneider, of the Board's Division of Research and Statistics, prepared this article

On March 26 and 27, 2004, the Federal Reserve Board held a conference in Washington, D.C , on the application of economic models to the analysis of monetary policy issues The papers presented at the conference addressed several topics that, because they are of interest to central bankers, have been a prominent feature of Federal Reserve research over the years. In particular, the papers represent research in the tradition of work carried out over the past thirty-five years at the Federal Reserve by three prominent staff economists—Dale W Henderson, Richard D. Porter, and Peter A. Tinsley Thus, the conference partly served as a celebration of the contributions made by these individuals to policy-related research since the late 1960s

Among the specific topics addressed at the conference were the influence of uncertainty on policymaking; the design of formal rules to guide policy actions; the role of money in the transmission of monetary policy; the determination of asset prices, and econometric techniques for estimating dynamic models of the economy This summary discusses the papers in the order presented at the conference.[1]

[1] The conference sessions also included a panel consisting of Ben S Bernanke, William Poole, and John B Taylor, who discussed the current state of central bank research and likely directions for future work A list of the conference papers appears at the end of this article along with an alphabetical list of authors and their affiliations at the time of the conference For a limited period, the papers will be available at www federalreserve gov/events/conferences/mmp2004/program htm In early 2005, the Federal Reserve Board will publish a conference volume that will include a revised version of each conference paper, commentaries on each paper by the conference discussants, and an appreciation summarizing the careers of Henderson, Porter, and Tinsley

LARS PETER HANSEN AND THOMAS J SARGENT

One way that economists gain insights about how to make sound economic decisions in an uncertain world is to study simple problems in which the optimal way to behave can be unambiguously derived In the 1950s, Herbert Simon and Henri Theil derived a simple principle that has been central to the study of economic decisionmaking under uncertainty.[2] Under their assumptions, they show that the optimal choice under uncertainty can be derived in two steps First, form your best forecast of the relevant unknown variables, and second, act as you would if you were certain that your forecast would come true. This result has come to be known as the *certainty-equivalence* principle· Once one forms the best forecast of future conditions, the nature and the degree of uncertainty play no further role in decisionmaking As might be expected, certainty equivalence applies only under very restrictive conditions, and economists have extensively studied cases in which the certainty-equivalence principle does not generate the best possible decisions Nonetheless, certainty equivalence remains an important benchmark case to consider and has proven extremely useful both in understanding more-complicated theoretical cases and in thinking about real-world problems

A critical assumption underlying the certainty-equivalence principle is that decisionmakers, be they households, firms, or policymakers, know the true model of the economy No one knows, of course, the full, true nature of the economy Thus, households, firms, and policymakers may find it appropriate to take this uncertainty into account in deciding how to act In "'Certainty Equivalence' and 'Model Uncertainty'," Lars Peter Hansen and Thomas J. Sargent consider economic decisionmaking under model

[2] Herbert Simon (1956), "Dynamic Programming under Uncertainty with a Quadratic Criterion Function," *Econometrica*, vol 24, pp 74–81, and Henri Theil (1957), "A Note on Certainty Equivalence in Dynamic Planning," *Econometrica*, vol 25, pp 346–49

uncertainty. In their paper, the decisionmaker does not know the true model of the economy but knows only a set of models containing the true model. The authors' approach differs from Bayesian decision theory, in which the decisionmaker assigns to each model a probability that it is the true one and then chooses the decision that is the best response on average across all the competing models. Instead, Hansen and Sargent consider a form of "robust decisionmaking" in which the decisionmaker chooses the decision that maximizes his or her welfare in the worst-case scenario—that is, when the true model turns out to be the worst possible model from the standpoint of the agent. Robust decisionmaking is quite complicated, especially if what happens to be the worst-case model depends on which decision the agent chooses.

The paper shows that, even under this cautious approach to taking account of model uncertainty, a surprising and useful version of the certainty-equivalence principle prevails Once again, the optimal decision under uncertainty can be seen as the solution of an equivalent problem under certainty In this case, however, one does not take as certain the best objective forecast of the relevant variables; rather, the forecast is "tilted" or "twisted" in a particular way to reflect the agent's desire to minimize suffering if the worst-case model prevails. The results of the paper shed light on the nature of the cautious behavior induced by the desire for decisions that are robust in this way.

The paper also provides important insights into the way to analyze this sort of decisionmaking. The solution is cast as the result of an imaginary two-player game in which a fictional opposing player maliciously chooses the worst possible model for the agent. Further, the paper shows that the robust decisionmaking can be interpreted as a form of Bayesian decisionmaking in which, once again, the probabilities of outcomes are twisted in a particular way to reflect the desire for robustness

JOHN C. WILLIAMS

The pervasive nature of structural change in the economy presents a great challenge for macroeconomic modeling and policy analysis, in no small part because it significantly complicates the estimation of the data-generating processes of key unobserved variables, such as the natural rates of interest and unemployment. Traditionally, evaluating macroeconomic policy using econometrics has involved two steps The first step tackles the estimation of a model of the economy, including the unobserved natural rates of interest and unemployment. In the second step, the best policy is selected by employing the estimated model and natural rate variables as if they were free of estimation error. This two-step approach has proven attractive because separating model estimation from policy selection simplifies analysis. Under certain strong assumptions, the certainty-equivalence principle suggests that one can find the best policy by first modeling key variables and then choosing the policy as if the model's forecasts were certain to come true.[3]

Because the certainty-equivalence principle assumes knowledge of the true model of the economy, it implies precise knowledge of the equations determining unobserved variables such as the natural rates of interest and unemployment, a requirement that is surely not satisfied in the case of monetary policymaking The uncertainty regarding modeling these natural rates has many sources, but one of the most important seems to be the presence of structural change in the macroeconomy.

In "Robust Estimation and Monetary Policy with Unobserved Structural Change," John C Williams examines, through an estimated model of the U.S. economy, the quantitative significance of structural change for the implementation of monetary policy. Williams first documents the considerable uncertainty associated with modeling the natural rates of interest and unemployment. The data are insufficiently informative to allow a clear choice among alternative estimated models for either natural rate. Importantly, as Williams shows, the policy suggested by applying the certainty-equivalence principle to one of these models often will lead to very poor policy outcomes if one of the other models happens to be true. The problem seems to arise mainly from the differences in the natural rate models The costs of improperly ignoring uncertainty about the natural rates are especially pronounced in terms of the variability of inflation. The certainty-equivalent policies suggest that policymakers have considerable ability to limit fluctuations in both output and inflation, but this result seems to rest heavily on the model in question being exactly correct. When applied in other models that fit the data about as well, the suggested policies are often far from optimal

In light of his finding, Williams investigates alternative solutions to the joint problem of estimation and policy feedback in the presence of uncertainty about how to model the natural rates of interest

3 As discussed earlier, the first step involves forming a "best forecast" of key variables Under standard assumptions, that forecast will come from estimating the correct econometric model

and unemployment He identifies strategies that are robust in the sense of providing very good policy outcomes no matter which model is correct. He finds that estimating these natural rates using simple estimators such as weighted averages of sample means performs well for the purpose of formulating robust policy. He also finds that, with these estimators, the optimal policy under uncertainty incorporates a significant degree of policy inertia—that is, a dependence of the current interest rate setting on its value in the previous period—and responds less aggressively to perceived unemployment gaps than certainty equivalence would suggest Finally, he shows that adopting this joint estimation and control procedure proves highly effective at mitigating the effects of misspecification and mismeasurement of the natural rates of interest and unemployment

JEFFREY C. FUHRER AND GIOVANNI P. OLIVEI

Understanding why important economic indicators such as unemployment, output, and inflation gradually rise and fall over the business cycle is of central importance to many macroeconomic issues, including the optimal conduct of monetary policy. At least since the work of John Maynard Keynes, macroeconomists have debated the business-cycle role of "sticky" prices and wages—prices and wages that respond only sluggishly to new conditions. Sticky prices have the potential to give a special role to expectations of future economic conditions. If, say, a manufacturer is going to post and maintain a price for an extended period, he or she needs to take account of not only current conditions but also the conditions expected to prevail over the extended period The nature and the degree of such forward-looking price-setting behavior have important consequences for an understanding of the optimal response of monetary policy to the business cycle; hence, building an empirical model that provides a realistic account of the way expectations feed into prices and wages is a critical—and hotly debated—area of research.

The central issue in this research concerns the degree to which price setters look to the future. Are they *inertial*, that is, focused on current or past conditions? Or are they mainly *forward looking*, that is, focused on projected conditions in the period over which the price will hold? The difficulty in this literature is that, in either case, current prices could explain future prices. In the inertial explanation, current prices are a fairly direct determinant of future prices Under the forward-looking explanation, last month's prices explain next month's because past prices are a good predictor of future prices If pricing behavior is somewhat inertial, both these explanations are likely to be correct, and sorting out their relative importance raises subtle econometric issues Clearly, if one can find economic variables that behave very differently depending on which case is correct, these variables can be used to help settle the issue. Econometricians call such variables *instruments*.[4]

In "Estimating Forward-Looking Euler Equations with GMM Estimators: An Optimal Instruments Approach," Jeffrey C. Fuhrer and Giovanni P. Olivei compare different methods for choosing instrumental variables in the estimation of forward-looking output and inflation equations.[5] They follow earlier work in showing that the instrumental variables used in conventional estimation of such equations are weak—the behavior of the instruments in the forward-looking case do not differ much from that in the inertial case. To mitigate this problem, the authors propose an estimation procedure based on instrumental variables that exploits more completely the differential predictions of the two theories.[6] They call this procedure an "optimal instruments" approach and show that it has some desirable statistical properties (for example, it shares some of the properties of maximum-likelihood estimation). The authors use computer simulations to show that the new approach substantially resolves the weak-instruments problem and that, in contrast with the conventional method, the estimates of key parameters obtained using the new method tend to be about right on average. Further, the optimal-instruments method provides a more stringent test of the hypothesis of forward-looking behavior because the method more completely assesses the predictions of the model.

The authors show, through simulations, that the estimates made with the optimal-instruments approach should be more reliable than those made with conventional techniques, then they apply the method to equations for output and for inflation using U.S data. For both relations, the estimates using the new method indicate a much larger inertial component, and hence a smaller role for forward-

4 To clearly resolve which theory is correct, econometricians need variables that meet certain conditions for valid instruments In the current case, the goal is to estimate the role of expected future conditions—as opposed to recent past conditions—in setting prices Because price expectations are not directly observed in the economy, a useful instrumental variable would, say, rise when price expectations rise for reasons other than a rise in current prices

5 GMM is the abbreviation for general method of moments

6 More formally, the instruments are based on imposing the restrictions of the forward-looking model regarding how current variables should affect expectations of the future

looking behavior, than is suggested by conventional estimation

Pierpaolo Benigno and Michael Woodford

In "Optimal Stabilization Policy when Wages and Prices Are Sticky The Case of a Distorted Steady State," Pierpaolo Benigno and Michael Woodford consider the optimal design of monetary policy when both prices and wages display considerable inertia The authors are especially interested in whether the recent findings of Christopher J Erceg, Dale W. Henderson, and Andrew T. Levin hold in the context of a more general model of the economy.[7] In their model, Erceg, Henderson, and Levin assumed the existence of output and employment subsidies that eliminate any distortions arising from the market power of monopolistically competitive firms As a result, a monetary policy that stabilizes prices yields a steady-state level of output that is efficient. Benigno and Woodford point out, however, that the property of efficiency does not hold in the absence of such subsidies Under more-realistic assumptions about subsidies and taxes, stabilization policy will influence not only the steady-state variability of wages, prices, and output but also the average equilibrium levels of these factors Thus, optimal monetary policy under these more-general conditions involves a more complicated set of tradeoffs and may imply central bank behavior that differs significantly from that derived from a simpler model

To investigate this possibility, Benigno and Woodford extend the analysis of Erceg, Henderson, and Levin by using a model in which the steady-state level of output under a zero-inflation policy is suboptimal because of tax distortions and market power. Like the previous researchers, Benigno and Woodford find that the expected utility of the representative household can be approximated by a quadratic loss function with no linear terms, a result implying that the welfare associated with a given policy rule can still be readily evaluated (to second-order accuracy) using a first-order-accurate solution of the model Also, they continue to find that the welfare-theoretic loss function has three terms capturing the distortions arising from nonzero levels of wage inflation, price inflation, and an appropriately defined measure of the output gap.

The existence of a distorted steady state in the more-general model, however, does influence the weight placed on each of the three objectives In addition, tax distortions and market power alter the definition of target output used to compute the output gap, thereby causing the target rate of output to diverge from the equilibrium output level that would obtain under fully flexible wages and prices. As a result, the simple policy rules of the sort that Erceg, Henderson, and Levin considered—that is, rules that stabilize a weighted average of wage and price inflation with no reference to the output gap, or rules that stabilize a weighted average of price inflation and the output gap with no reference to wages—appear to be poorer in their approximation of the fully optimal strategy

Nonetheless, Benigno and Woodford find that the main conclusion of the earlier work remains valid: If wages are sticky, then variations in wages give rise to distortions similar to those caused by variations in sticky prices, and monetary policy should act to mitigate welfare losses associated with both factors. Under such circumstances, targeting price inflation alone will be suboptimal, and appreciable welfare gains will ensue from targeting prices, wages, and the output gap

Matthew B Canzoneri, Robert E. Cumby, and Behzad T. Diba

Since the early 1990s, many central banks have adopted price inflation targeting as a framework for implementing monetary policy Although central banks have chosen this strategy for various reasons, the literature on monetary policy design suggests one motivation avoiding persistent movements in the price level, which give rise to economic distortions that reduce the welfare of households. This reduction in welfare arises in the context of a class of models that economists often use to characterize the workings of the economy—the so-called New Neoclassical Synthesis (NNS) If prices exhibit significant inertia, policymakers avoid the loss of household welfare in an optimal way if they fix the aggregate price level. However, the recent work of Erceg, Henderson, and Levin has called this conclusion into question.[8] In particular, their findings suggest that if the NNS model is generalized to allow for inertia in nominal wages, then, by targeting prices alone, the central bank no longer maximizes consumer welfare To do so, it must instead respond to movements in both

7 Christopher J Erceg, Dale W Henderson, and Andrew T Levin (2000), "Optimal Monetary Policy with Staggered Wage and Price Contracts," *Journal of Monetary Economics*, vol 46 (October), pp 281–313

8 Erceg, Henderson, and Levin, "Optimal Monetary Policy"

prices and nominal wages or to movements in prices and one of the main determinants of wages, the output gap.

In "Price and Wage Inflation Targeting. Variations on a Theme by Erceg, Henderson, and Levin," Matthew B. Canzoneri, Robert E Cumby, and Behzad T Diba expand upon this recent work by investigating the potential benefits of targeting both prices and nominal wages. They use the standard NNS model to see how social welfare is influenced by the adoption of different monetary policy rules for responding to macroeconomic disturbances. They use variations of the NSS model to determine which aspects of the economy have an important bearing on the relative merits of price and wage targeting Among the variations are specifications with and without distortions arising from monopolistic competition, specifications with different treatments of capital and its role in the production process, and specifications that allow for random disturbances to consumer spending and for productivity shocks.

Canzoneri, Cumby, and Diba derive three main conclusions from their analysis. First, they find that incorporating capital into the model has a significant quantitative effect on their results. The way in which capital enters the model appears to be less important, however, in particular, making the sale of existing capital uneconomic, a move implying that existing capital is firm-specific, does not have large normative implications. Second, under a policy that adjusts interest rates to inflation prospects alone, a level of price fluctuation exists below which rate tightening does not pay. In contrast, under a policy that targets only wages, the tighter the targeting rule, the better. Third, and perhaps most surprising, a policy of aggressively targeting nominal wages leads to better outcomes than a policy of targeting only price inflation. For example, for a particular specification of the economic model, targeting price inflation imposes welfare costs that are greater than those imposed by a wage-targeting strategy designed to yield the same volatility of price inflation. Finally, Canzoneri, Cumby, and Diba find that hybrid rules—those in which interest rates respond to movements in both prices and wages—do not lead to much better policy outcomes than does a policy of aggressively targeting nominal wages, a finding that contrasts with previous findings in this field

BENNETT T. MCCALLUM AND EDWARD NELSON

In their paper "Targeting vs. Instrument Rules for Monetary Policy," Bennett T. McCallum and Edward Nelson compare alternative ways to characterize rule-based monetary policy Traditionally, the term *monetary policy rule* has been used in the sense of "instrument rules"—specific formulas for setting the federal funds rate, money growth, or some other controllable instrument in response to current economic conditions, as measured by recent data or forecasts. However, in the ongoing debate regarding the best way to characterize rule-based monetary policy, so-called targeting rules have been proposed as an alternative. Unlike instrument rules, targeting rules do not describe explicitly how the policy instrument must be set. Rather, they convey the implicit prescription that policy must attain the policymaker's objective

Two variants of these implicit rules have been suggested A *general targeting rule* describes the specification of a central bank's objective function, whereas a *specific targeting rule* is a description of optimal policy behavior derived from both the central bank's objective function and a model of the economy.[9] With regard to the general targeting rule, McCallum and Nelson argue that referring to the specification of the policymaker's objective as a rule seems inappropriate. Instead, they think that clearly distinguishing between the terms *objectives* and *rules* is useful in policy analysis

McCallum and Nelson examine in detail the specific targeting rules approach and compare it with the instrument-rules approach. Because specific targeting rules are, by definition, optimality conditions, their implicit policy prescriptions might seem better suited for describing optimal policy, such as the optimal-control approach to monetary policy design As McCallum and Nelson point out, however, conditions that imply optimality in one model may be highly inappropriate in other specifications, as is the case with any optimal-control exercise. The optimality of the suggested solution is conditioned on accepting the assumed model structure as true beyond any doubt, a stance that is untenable in light of the ongoing dispute among economists concerning the proper specification of a model for the macroeconomy. Thus, McCallum and Nelson argue in favor of the traditional policy rules analysis, which attempts to identify simple rules that are robust to alternative model specifications

The authors examine some possible limitations of simple rules that have sometimes been cited as arguments in favor of specific targeting rules: (1) Simple rules may omit from consideration important factors not included in the rule, (2) they may require judg-

9 The description of the optimal behavior generally comes in the form of a first-order condition for optimal policy

mental adjustments, (3) they cannot be seen as once-and-for-all commitments because they must allow for modifications reflecting improvements to our knowledge, and (4) they may not accurately reflect the current practice of central banks. After examining these limitations in detail, McCallum and Nelson conclude that they do not present any compelling argument for preferring the specific targeting rules approach over the traditional policy rules analysis. In addition, McCallum and Nelson conduct several analytical exercises to examine whether implementation of targeting rules might result in lower interest rate variability relative to that associated with simple instrument rules. They show that, in their framework, once the relevant policy implementation errors for the two alternative approaches are properly accounted for, targeting rules generally result in greater interest rate variability.

DAVID L. KELLY AND STEPHEN F. LEROY

The concept of liquidity plays a central role in the understanding of asset markets. One commonly thinks of money as the most liquid asset and of physical assets such as factories and houses as very illiquid. However, formal modeling of the features that make some assets more liquid than others has proven very difficult. Although everyone may agree that an asset is illiquid if it is difficult, costly, or time consuming to sell at a price close to its fair market value, the precise meanings of "difficult" and "fair" are not obvious in this context. Economists often use the term *frictions* to describe the collection of factors that make some assets less liquid than others. In part because modeling these frictions has proven so difficult, an important branch of research in macroeconomics omits them or treats them in an elementary manner. Under standard simplifications, for example, monetary policy makers can ignore the fact that factories are less liquid than Treasury bills.

In "Liquidity and Fire Sales," David L. Kelly and Stephen F. LeRoy study one familiar aspect of liquidity—the fact that, for certain illiquid assets, the price they could fetch if the seller had to sell immediately might be considerably below what the assets could fetch if the seller waited for "the right" buyer. In this sense, houses are illiquid assets, whereas certain financial assets, such as Treasury bills, are quite liquid. Of course, sellers of houses generally attempt to be patient so that they can obtain something close to the best possible price, but occasionally one finds houses "priced to sell" by someone who has reason to be less patient. The latter case is a "fire sale"—the sale of an asset at a price lower than the price that potential buyers, if they could be identified, would willingly pay.

Kelly and LeRoy formally study the notions of liquidity and fire sales as manifested in the market for the assets of a firm. The broadest features of the issue that the authors identify are relatively straightforward to understand. If the current owners are profitably operating the firm, they may be willing to sell it at an attractive price, but they will be in no hurry to do so. They certainly will not sell the firm at a fire-sale price. If the owners are currently operating at a loss, however, they may be able to find buyers who could operate the firm more profitably. The question for the current owners then becomes how aggressively to price the firm's assets. If the possible buyers have a wide range of valuations for the assets, then pricing becomes difficult. If the owner sets a fire-sale price, he or she may quickly find a willing buyer and limit the losses. Setting a higher price means waiting longer to find a buyer who values the assets most highly. This tactic is sensible if the higher price more than covers the extra losses incurred by waiting. The reasoning is sound, but it does not answer the question of exactly how various factors affect the price.

Economists have derived useful formulas describing the pricing of liquid assets, such as the Black–Scholes option pricing formula, but they have found that deriving expressions for the pricing of illiquid assets is more difficult. This paper, which extends some earlier work by the authors and others aimed at deriving concrete implications of illiquidity, is composed mainly of an extended example. The example illustrates why fire-sale discounts occur in illiquid markets, it also shows that, in such markets, the fire-sale discounts may be sizable, whereas in liquid markets, a small discount is sufficient to ensure a quick sale.

MARVIN GOODFRIEND

Monetary policy analysis is commonly examined in the context of models with a greatly simplified mechanism of monetary transmission. Such models ignore the central bank's control of the money supply and focus exclusively on the short-run nominal interest rate for monetary policy. Invariably, such models also fail to draw a distinction between narrow money (bank reserves) and broad money (bank deposits) and rule out, by assumption, financial frictions that may be important for understanding the role of financial intermediation in the economy.

In his paper "Narrow Money, Broad Money, and the Transmission of Monetary Policy," Marvin Goodfriend develops a framework that integrates broad money demand with loan production, asset pricing, and arbitrage between banking and asset markets in order to explore the supply of and demand for broad money and the potential role of broad money in monetary transmission. The demand for broad money arises from at least two problems: First, not all markets that agents might want to use exist; second, agents are subject to uninsurable, idiosyncratic shocks.[10] Banks hold household demand deposits and use funds to make loans, subject to the collateral available in the economy and the effort needed to monitor loan performance. Goodfriend shows that the resulting macroeconomic equilibrium is considerably more complex than that obtained in traditional, greatly simplified monetary models. For instance, among the standard factors determining the observed net real returns on capital and bonds is the time preference of agents—the rate at which agents trade consumption today for consumption tomorrow. But the return on capital and bonds also depends on the broad liquidity services they may provide as collateral for loans.

Goodfriend uses the model to explore the links between the broad liquidity services that bank deposits provide and the scope for monetary policy makers to use the instruments of narrow money and the nominal interest rate to manage, react to, and take account of broad liquidity. Among other things, Goodfriend shows how the neutral level of an interbank interest rate policy instrument depends on factors affecting the provision of broad liquidity. He demonstrates that, although interest rate policy automatically insulates the economy against shocks to narrow liquidity, such policy must be modified to offset the effect on the economy of shocks to broad liquidity. In general, broad-liquidity conditions need to be taken into account in the pursuit of interest rate policy because (1) they influence the link between the interbank rate and market interest rates through their effect on the premium firms must pay to raise funds to finance illiquid investments and (2) they affect the behavior of market interest rates that the central bank must target in order to maintain overall macroeconomic stability with stable prices.

10. For example, when setting out on a sunny day, one must consider that trading one's bottle of sunscreen for an umbrella may be difficult should the weather change One could hope to find a market in which to complete this trade or to buy insurance against this outcome, but carrying money with which to buy an umbrella should the need arise may be simpler

The lists of papers and authors appear on page 296.

CONFERENCE PAPERS

Benigno, Pierpaolo, and Michael Woodford "Optimal Stabilization Policy when Wages and Prices Are Sticky: The Case of a Distorted Steady State."

Canzoneri, Matthew B., Robert E Cumby, and Behzad T. Diba. "Price and Wage Inflation Targeting: Variations on a Theme by Erceg, Henderson, and Levin."

Fuhrer, Jeffrey C., and Giovanni P Olivei "Estimating Forward-Looking Euler Equations with GMM Estimators: An Optimal Instruments Approach "

Goodfriend, Marvin. "Narrow Money, Broad Money, and the Transmission of Monetary Policy "

Hansen, Lars Peter, and Thomas J Sargent " 'Certainty Equivalence' and 'Model Uncertainty'."

Kelly, David L., and Stephen F. LeRoy "Liquidity and Fire Sales."

McCallum, Bennett T, and Edward Nelson. "Targeting vs Instrument Rules for Monetary Policy."

Williams, John C. "Robust Estimation and Monetary Policy with Unobserved Structural Change."

AUTHORS

Affiliations are as of the time of the conference.

Pierpaolo Benigno
New York University

Matthew B. Canzoneri
Georgetown University

Robert E. Cumby
Georgetown University

Behzad T Diba
Georgetown University

Jeffery C. Fuhrer
Federal Reserve Bank of Boston

Marvin Goodfriend
Federal Reserve Bank of Richmond

Lars Peter Hansen
University of Chicago

David L Kelly
University of Miami

Stephen F. LeRoy
University of California, Santa Barbara

Bennett T. McCallum
Carnegie Mellon University and National Bureau of Economic Research

Edward Nelson
Federal Reserve Bank of St Louis and Centre for Economic Policy Research

Giovanni P. Olivei
Federal Reserve Bank of Boston

Thomas J. Sargent
New York University and Hoover Institution, Stanford University

John C. Williams
Federal Reserve Bank of San Francisco

Michael Woodford
Princeton University □

Credit Report Accuracy and Access to Credit

Robert B. Avery, Paul S Calem, and Glenn B Canner, of the Board's Division of Research and Statistics, prepared this article Shannon C Mok provided research assistance

Information that credit-reporting agencies maintain on consumers' credit-related experiences plays a central role in U.S. credit markets. Creditors consider such data a primary factor when they monitor the credit circumstances of current customers and evaluate the creditworthiness of prospective borrowers. Analysts widely agree that the data enable domestic consumer credit markets to function more efficiently and at lower cost than would otherwise be possible

Despite the great benefits of the current system, however, some analysts have raised concerns about the accuracy, completeness, timeliness, and consistency of consumer credit records and about the effects of data limitations on the availability and cost of credit These concerns have grown as creditors have begun to rely more on "credit history scores" (statistical characterizations of an individual's creditworthiness based exclusively on credit record information) and less on labor-intensive reviews of the detailed information in credit reports Moreover, decisionmakers in areas unrelated to consumer credit, including employment screening and underwriting of property and casualty insurance, increasingly depend on credit records, as studies have shown that such records have predictive value

A previous article in this publication examined in detail the credit records of a large, nationally representative sample of individuals as of June 30, 1999.[1] That analysis revealed the breadth and depth of the information in credit records It also found, however, that key aspects of the data may be ambiguous, duplicative, or incomplete and that such limitations have the potential to harm or to benefit consumers

Although the earlier analysis contributed to the debate about the quality of the information in credit records, it did not attempt to quantify the effects of data limitations on consumers' access to credit. To date, publicly available information about the extent of data quality problems has been limited, as has research on the effects of those problems[2] The lack of information has inhibited discussion of the problems and of the appropriate ways to address them.

The main reason for the lack of information is that conducting research on the effects of data limitations on access to credit is complicated. Two factors account for the complexity. First, the effects vary depending on the overall composition of the affected individual's credit record For example, a minor error in a credit record is likely to have little or no effect on access to credit for an individual with many reported account histories, but the same error may have a significant effect on access to credit for someone with only a few reported account histories. Second, assessments of the effects of data limitations require detailed knowledge of the model used to evaluate an individual's credit history and of the credit-risk factors that compose the model Because information about credit-scoring models and their factors is ordinarily proprietary, it is difficult to obtain.

In this article, we expand on the available research by presenting an analysis that tackles these complexities and quantifies the effects of credit record limitations on the access to credit[3] The analysis considers the credit records of a nationally representative sample of individuals, drawn as of June 30, 2003, that incorporates improvements in the reporting system over the past few years and, consequently, better reflects today's circumstances. We examine the possible effects of data limitations on consumers by estimating the changes in consumers' credit history scores that would result from "correcting" data problems in their credit records. We also investigate

1 Robert B Avery, Raphael W Bostic, Paul S Calem, and Glenn B Canner (2003), "An Overview of Consumer Data and Credit Reporting," *Federal Reserve Bulletin*, vol 89 (February), pp 47–73

2 General Accounting Office (2003), *Consumer Credit Limited Information Exists on Extent of Credit Report Errors and Their Implications for Consumers*, report prepared for the Senate Committee on Banking, Housing, and Urban Affairs, GAO-03-1036T, July 31, pp 1–18. In 2004, the General Accounting Office became the Government Accountability Office

3 This analysis builds on recent research that attempted to quantify the effects of credit record limitations on the access to credit See Robert B Avery, Paul S Calem, and Glenn B Canner (2003), "Credit Reporting and the Practical Implications of Inaccurate or Missing Information in Underwriting Decisions," paper presented at "Building Assets, Building Credit A Symposium on Improving Financial Services in Low-Income Communities," Joint Center for Housing Studies, Harvard University, November 18–19

whether different patterns emerge when individuals in the sample are grouped by strength of credit history (credit history score range), depth of credit history (number of credit accounts in a credit record), and selected demographic characteristics (age, relative income of census tract of residence, and percentage of minorities in census tract of residence). Such segmentation allows us to determine whether the effects of data limitations differ for various subgroups of the population.

CONSUMER CREDIT REPORTS

A consumer credit report is the organized presentation of information about an individual's credit record that a credit-reporting agency communicates to those requesting information about the credit history of an individual. It includes information on an individual's experiences with credit, leases, non-credit-related bills, collection agency actions, monetary-related public records, and inquiries about the individual's credit history. Credit reports, along with credit history scores derived from the records of credit-reporting agencies, have long been considered one of the primary factors in credit evaluations and loan pricing decisions. They are also widely used to select individuals to contact for prescreened credit solicitations. More recently, credit reports and credit history scores have often been used in identifying potential customers for property and casualty insurance and in underwriting and pricing such insurance [4]

The three national credit-reporting agencies—Equifax, Experian, and Trans Union—seek to collect comprehensive information on all lending to individuals in the United States, and as a consequence, the information that each agency maintains is vast. Each one has records on perhaps as many as 1.5 billion credit accounts held by approximately 210 million individuals.[5] Together, these agencies generate more than 1 billion credit reports each year, providing the vast majority of the reports for creditors, employers, and insurers. One study found that consumers receive only about 16 million of the credit reports distributed each year [6]

Credit-reporting agencies collect information from "reporters"—creditors, governmental entities, collection agencies, and third-party intermediaries. They generally collect data every month, and they typically update their credit records within one to seven days after receiving new information. According to industry sources, each agency receives more than 2 billion items of information each month. To facilitate the collection process and to reduce reporting costs, the agencies have implemented procedures to have data submitted in a standard format, the so-called Metro format.[7] Data may be submitted through various media, including CD-ROM and electronic data transfer Reporters submit information voluntarily No state or federal law requires them to report data to the agencies or to use a particular format for their reporting As a result, the completeness and frequency of reporting can vary

Using Credit Records to Evaluate Creditworthiness

In developing credit history scores, builders of credit-scoring models consider a wide variety of summary factors drawn from credit records. In most cases, the factors are constructed by combining information from different items within an individual's credit record These factors compose the key elements of credit models used to generate credit history scores. Although hundreds of factors may be created from credit records, those used in credit-scoring models are the ones proven statistically to be the most valid predictors of future credit performance. The factors and the weights assigned to each one can vary across evaluators and their different models, but the factors generally fall into four broad areas: payment history, consumer indebtedness, length of credit history, and the acquisition of new credit.[8]

4 For purposes of insurance, the scores are typically referred to as insurance scores

5 John A Ford (2003), chief privacy officer of Equifax, Inc, in *Fair Credit Reporting Act How It Functions for Consumers and the Economy*, hearing before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services, House Hearing 108-33, 108 Cong 2 Sess (Washington Government Printing Office), June 4 Also see Consumer Data Industry Association (formerly Associated Credit Bureaus), "About CDIA," www cdiaonline org

6 Loretta Nott and Angie A Welborn (2003), *A Consumer's Access to a Free Credit Report A Legal and Economic Analysis*, report to the Congress by the Congressional Research Service, September 16, pp 1–14

7 Currently, reporters may submit data in the Metro I or Metro II format As of 2005, the Metro II format will be required for all submissions

8 For a more detailed discussion of factors considered in credit evaluation, including the relative weights assigned to different factors, see the description on the website of Fair Isaac Corporation, www myfico com Also see Robert B Avery, Raphael W. Bostic, Paul S Calem, and Glenn B Canner (1996), "Credit Risk, Credit Scoring, and the Performance of Home Mortgages," *Federal Reserve Bulletin*, vol 82 (July), pp 621–48

Payment History

The most important factors considered in credit evaluation are those that relate to an individual's history of repaying loans and any evidence of non-credit-related collections or money-related public actions. Credit evaluators consider whether an individual has a history of repaying balances on credit accounts in a timely fashion. The analysis takes into account not only the frequency of any repayment problems but also their severity (lateness), date of occurrence (newness), and dollar magnitude Evaluators assess repayment performance on the full range of accounts that an individual holds, distinguishing accounts by type (such as revolving, installment, or mortgage) and by source (such as banking institution, finance company, or retailer) In general, an individual with serious deficiencies in repayment performance, such as a credit account that is currently delinquent, will find qualifying for new credit difficult, may face higher interest rates for the credit received, or may be limited in further borrowing on existing revolving accounts

Consumer Indebtedness

When evaluating credit, creditors consider the type and amount of debt an individual has and the rate of credit utilization. For revolving accounts, the rate of credit utilization is measured as the proportion of available credit in use (outstanding balance divided by the maximum amount the individual is authorized to borrow, referred to as the credit limit). For installment and mortgage accounts, credit utilization is generally measured as the proportion of the original loan amount that is unpaid. High rates of credit utilization are generally viewed as an additional risk factor in credit evaluations, as they may indicate that an individual has tapped all available credit to deal with a financial setback, such as a loss of income.

Length of Credit History

Credit evaluators consider the length of a person's credit history because it provides information about how long the individual has been involved in credit markets and about whether he or she has obtained credit recently. The age of the account is relevant to an evaluation of credit quality because the longer the account has been open, the more information it conveys about an individual's willingness and ability to make payments as scheduled New accounts may convey little information other than that a consumer has had a recent need for additional credit and has been approved for credit.

Acquisition of New Credit

Whether a person is seeking new credit provides information about the credit risk posed by the individual. The number of new accounts the individual has recently established and the number of attempts to obtain additional loans, as conveyed by records of recent creditor inquiries (requests for credit reports), all provide a picture of the individual's recent credit profile.[9] Attempts to open a relatively large number of new accounts may signal that a person risks becoming overextended.

Calculating a Credit History Score

Statistical modelers working with data from credit-reporting agencies construct credit history scores using selected factors of the types described above. Modelers divide each factor into ranges and assign each range a point count. The score for an individual is the sum of these points over all factors considered in the model Typically, the points and the factors used in the model are derived from a statistical analysis of the relationship between the factors at an initial date and the credit performance over a subsequent period.

Role of the Fair Credit Reporting Act

Although participation by reporters in the credit-reporting process is voluntary, reporters are subject to rules and regulations spelled out in the Fair Credit Reporting Act (FCRA). The FCRA regulates access to credit information and prescribes how the agencies are to maintain each credit report they hold [10] Under the FCRA, only persons with a permissible pur-

9 Inquiries made to create a mailing list for sending prescreened solicitations or to monitor existing account relationships are omitted from the credit reports Also omitted are individuals' requests for copies of their own reports

10 For a discussion of how the FCRA governs and encourages accurate credit reporting, see Michael Staten and Fred Cate (2003), "Does the Fair Credit Reporting Act Promote Accurate Credit Reporting?" paper presented at "Building Assets, Building Credit A Symposium on Improving Financial Services in Low-Income Communities," Joint Center for Housing Studies, Harvard University, November 18-19

Provisions of the Fair and Accurate Credit Transactions Act of 2003

The Fair and Accurate Credit Transactions Act of 2003 amended the Fair Credit Reporting Act in several ways. The amendments, known collectively as the FACT Act, seek to (1) improve the use of credit information and give consumers greater access to such information, (2) prevent identity theft and facilitate credit history restitution, (3) enhance the accuracy of consumer report information, (4) limit the sharing and use of medical information in the financial system, and (5) improve financial literacy and education

The amendments that address the use and availability of credit information provide the following consumer rights and protections

• **The right to obtain a free copy of a consumer report.** A consumer may request a free credit report once a year from each of the national credit-reporting agencies, and each agency must establish a toll-free telephone number to receive the requests A consumer may also obtain a credit history score and related information from each agency for a "fair and reasonable" fee. For a given credit history score, related information includes the range of possible scores under the model used to produce the score, a list of the key factors (not to exceed four) that adversely affected the score, the date the score was established, and the name of the entity that provided the score.

• **The right to be told when, as a result of negative information in a credit report, a creditor has offered a consumer credit on terms that are materially less favorable than those offered to most other consumers.** At the time of notification, the creditor must provide a statement that explains the consumer's right to obtain a free credit report from a credit-reporting agency and that provides contact information for obtaining the report (as of this writing, the rules for implementing this provision were not yet final).

• **Protection against faulty reporting of credit record data.** Federal supervisors of financial institutions must establish and maintain guidelines regarding the accuracy and integrity of the information that data reporters submit to credit-reporting agencies. In certain circumstances, a data reporter must reinvestigate a dispute involving the information it reported.

pose for obtaining a credit report—for example, to facilitate a credit transaction, to screen prospective employees, or to underwrite property and casualty insurance involving a consumer—may have access to this credit information. The FCRA prohibits a reporter from furnishing any information to a credit-reporting agency if the reporter knows or consciously avoids knowing that the information is inaccurate, and the act requires reporters to help correct errors that consumers have identified.

The FCRA also prescribes the responsibilities of the reporters and the agencies when a consumer challenges the accuracy of information in a credit record. Within thirty days after a dispute has been filed, a credit-reporting agency must remove or correct inaccurate, incomplete, or unverified information in a consumer's credit record In addition, anyone using information in a credit report to take adverse action against a consumer (for example, denying a request for credit) must notify the consumer that the report has been used in the decision. Such consumers are entitled to free copies of their reports [11]

Amendments to the FCRA—enacted December 4, 2003, as the Fair and Accurate Credit Transactions Act (FACT Act)—expand consumer access to credit reports and credit history scores and address issues of data accuracy and identity theft (see box "Provisions of the Fair and Accurate Credit Transactions Act of 2003"). The provisions also expand the duties of creditors to advise a consumer when, as a consequence of information in a credit report, the consumer is offered credit on terms materially less favorable than those made available to most other customers. For the most part, the amendments will become effective at the end of 2004.

Accuracy, Completeness, Timeliness, and Consistency of Credit Record Information

Credit-reporting agencies use various techniques and editing procedures to process the information they receive and to assess its accuracy, completeness, timeliness, and consistency. If they discover or suspect that the data contain errors, they return the data to the reporter for resubmission with any necessary corrections.[12] Otherwise, the agencies compile and process the newly received data to create or update the record of an individual's credit experiences This processing can sometimes be difficult and has the

11 About 85 percent of the credit reports that consumers receive each year are associated with adverse actions See Nott and Welborn, *A Consumer's Access to a Free Credit Report*, p 10

12 For example, if a reporter submits a file that includes a much larger or a much smaller number of records than have historically been received, then the agency will flag the file for review Similarly, if an unexpectedly large or an unexpectedly small percentage of the data items have a given characteristic (for example, the number of accounts sixty or more days late exceeds a designated threshold), then the agency will also flag the data for review

potential for error. For example, because data reporting is voluntary and because the ability of the agencies to enforce certain standards is limited, the agencies have had to devise techniques for recognizing that sometimes data items reported with the same identifying information, such as the same name, may actually be associated with different individuals Similarly, a social security number may be missing from or may be reported incorrectly in reported information on an individual. In such cases, the likelihood of associating the reported item with the wrong person increases significantly.

Although the agencies' data are extensive, they are incomplete in two respects. First, not all information on credit accounts held by individuals is reported to the agencies. Some small retailers and mortgage and finance companies do not report to the agencies, and individuals, employers, insurance companies, and foreign entities typically do not report loans they extend. Also, information on student loans is not always reported. Second, some accounts that are reported contain incomplete or out-of-date information. Sometimes creditors do not report or update information on the credit accounts of consumers who consistently make their required payments as scheduled or on the accounts of those who have been seriously delinquent in their payments, particularly accounts with no change in status. Similarly, credit limits established on revolving accounts, such as credit cards, are not always reported or updated. Moreover, creditors may not notify the agencies when an account has been closed, transferred, or assigned a new payment status. For example, sometimes creditors fail to report delinquent payments that are fewer than thirty or sixty days past due, and they report changes in payment status only when a more serious payment problem arises. Each of these possibilities contributes to problems of data completeness and integrity, and each has the potential to compromise the evaluation of an individual's creditworthiness

Another problem that may compromise credit evaluations concerns the timeliness of the data. The information reported on credit accounts reflects each account's payment status and outstanding balance as of a date shortly before the information is forwarded to the agencies. Thus, the information is sensitive to the date on which the information is forwarded For example, a credit account reported the day after a creditor has posted a payment to the account will show a smaller balance than will the same account reported the day before the posting. Similarly, the payment status reflected in a credit report is sensitive to timing; the record on an account may indicate no late payment problems on a given day but may show a delinquency if reported to the agency one or two days later

Besides the accuracy, completeness, and timeliness of information in a given credit record, the consistency of information about an individual across agencies is an issue of concern. The information may differ from agency to agency for several reasons First, the rules governing the processing of reported information differ across agencies. For example, each agency has its own rules for determining whether identifying information is sufficient to link reported information to a single individual. The inability to link reported information accurately in all cases can be an important source of data quality concerns because it results in the creation of "fragmentary files"—that is, multiple and therefore incomplete credit reports for the same individual—and sometimes in the assignment of the wrong credit records to an individual. Fragmentary files often result because consumers use different addresses or names (for example, after a marriage or a divorce), in some cases fraudulently, to obtain credit or other services. Each agency also has its own rules governing the treatment of out-of-date information, such as accounts last reported to have a positive balance. Second, the agencies receive and post information at different times. Third, a given reporter may provide information to one or two of the agencies but not to all three. Finally, changes made to disputed information may be reflected only in the credit records of the agency that received the disputed claim

Although the agencies endeavor to maintain high-quality data and accurate files, the degree to which consumer credit reports are accurate, complete, timely, or consistent across agencies is in dispute. Moreover, analysts disagree on the extent to which data errors and omissions affect credit history scores A recent analysis by the General Accounting Office (GAO) cites information drawn from the relatively few studies that have attempted to address data accuracy and importance.[13] Specifically, the GAO cites a 2002 joint study by the Consumer Federation of America and the National Credit Reporting Association that found evidence that the information included in the credit reports of any given individual can differ widely across agencies [14] This study also found that credit history scores based on data from the agencies can vary substantially regardless of whether the individual has a generally good or a generally bad credit

13 General Accounting Office, *Consumer Credit*

14 Consumer Federation of America and National Credit Reporting Association (2002), *Credit Score Accuracy and Implications for Consumers*, December 17, www consumerfed.org

history. As a consequence, the study concluded, "millions of consumers are at risk of being penalized by inaccurate credit report information and inaccurate credit scores."[15]

The GAO report also discusses research on errors and omissions that occur within the credit files of a single agency. The report highlights different perspectives on the data quality issue. For example, one investigation by a consumer organization estimated that up to 79 percent of credit reports may contain some type of error and that about 25 percent of all consumer credit reports may contain errors that can result in the denial of access to credit.[16] A study by Arthur Andersen and Company reviewing the outcomes for individuals who were denied credit and then disputed information in their credit reports concluded, however, that only a small proportion of the individuals were denied credit because of inaccurate information in their credit reports.[17]

THE FEDERAL RESERVE SAMPLE OF CREDIT RECORDS

The Federal Reserve Board obtained from one of the three national credit-reporting agencies the credit records (excluding any identifying personal or creditor information) of a nationally representative random sample of 301,000 individuals as of June 30, 2003.[18] The sample data omitted home addresses but included census tracts, states, and counties of residence. We used this geographic information with census 2000 files—which provide population characteristics, such as income, race, and ethnicity, by census tract of residence—to analyze the credit record data.

Four general types of credit-related information appear in credit records, including those in the Federal Reserve sample: (1) detailed information from creditors (and some other entities such as utility companies) on credit accounts—that is, current and past loans, leases, and non-credit-related bills; (2) information reported by collection agencies on actions associated with credit accounts and non-credit-related bills, such as unpaid medical or utility bills; (3) information purchased from third parties about monetary-related public records, such as records of bankruptcy, foreclosure, tax liens (local, state, or federal), lawsuits, garnishments, and other civil judgments; and (4) information about inquiries from creditors regarding an individual's credit record.

Credit accounts constitute the bulk of the information in the typical individual's credit record, and thus they compose the bulk of the information that the agencies maintain. Credit account records contain a wide range of details about each account, including the date that an account was established; the type of account, such as revolving, installment, or mortgage; the current balance owed; the highest balance owed, credit limits if applicable; and payment performance information, such as the extent to which payments are or have been in arrears for accounts in default.

A basic element of agency data is information on the open or closed status of each account. An account is considered open if a credit relationship is ongoing and closed if the consumer can no longer use the account. Another important element of account information is the date on which the information was most recently reported. The date is critical in determining whether the information on the account in the credit agency files is current or stale (unreported for some time and therefore potentially in need of updating).

Significantly less-detailed information is available on collection agency accounts, public records, and creditor inquiries about a consumer's credit history. Generally, only the amount of the collection or public record claim, the name of the creditor, and the date last reported are available. For creditor inquiries, information is even more limited and includes just the type of inquirer and the date of the inquiry. The

15 Consumer Federation of America and National Credit Reporting Association, *Credit Score Accuracy and Implications for Consumers*. The study found that the difference between the high and the low credit history scores for an individual across the three agencies averaged 41 points (on a scale of 300 to 850) and that about 4 percent of individuals had score differences of 100 points or more.

16 Alison Cassady and Edmund Mierzwinski (2004), *Mistakes Do Happen: A Look at Errors in Consumer Credit Reports*, National Association of State Public Interest Research Groups, June, www.uspirg.org. Also see Jon Golinger and Edmund Mierzwinski (1998), *Mistakes Do Happen: Credit Report Errors Mean Consumers Lose*, U.S. Public Interest Research Group, March, www.uspirg.org.

17 Consumer Data Industry Association (1998), press release, March 12, www.cdiaonline.org. Also see Robert M. Hunt (2002), "The Development and Regulation of Consumer Credit Reporting in America," Working Paper No. 02-21 (Philadelphia: Federal Reserve Bank of Philadelphia, November). The study found that 8 percent of the consumers who were denied credit requested copies of their credit reports. Of these consumers, 25 percent found and disputed errors. Of those consumers who found errors, about 12 percent (3 percent of those who requested credit reports) eventually received credit because of favorable dispute resolutions.

18 Agency files include personal identifying information that enables the agencies to distinguish among individuals and construct a full record of each individual's credit-related activities. The records received by the Federal Reserve excluded the personal identifying information that agency files contain—the consumer's name, current and previous addresses, and social security number—as well as other personal information that credit files sometimes contain—telephone numbers, name of spouse, number of dependents, income, and employment information. Under the terms of the contract with the credit-reporting agency, the data received by the Federal Reserve cannot be released to the public.

1 Individuals with credit-reporting agency records, by type of information in credit record, as of June 30, 2003

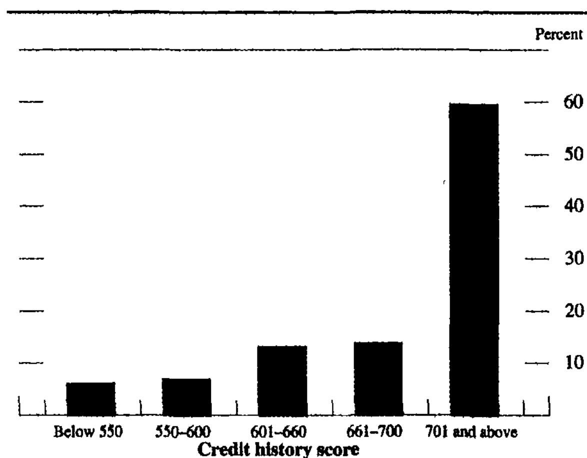
Type of information in credit record	Number	Share of sample (percent)
Sample size	**301,536**	**100.0**
Credit account	259,211	86 0
Collection agency account	109,964	36 5
Public record	36,742	12 2
Creditor inquiry[1]	188,616	62 6
None of the above	15	*
MEMO		
Credit account only	63,501	21 1
Collection agency account only	34,978	11.6
Public record only	53	*
Creditor inquiry only[1]	31	*
Credit account and		
Collection agency account	67,747	22 5
Public record	34,715	11 5
Creditor inquiry[1]	182,553	60 5

NOTE In this and subsequent tables, components may not sum to totals because of rounding

1 Item includes only inquiries made within two years of the date the sample was drawn

* Less than 0 5 percent

1 Distribution of individuals, by credit history score



NOTE Data are from a Federal Reserve sample drawn as of June 30, 2003 The distribution is composed of individuals in the sample who had been assigned credit history scores Authors have adjusted the scores, which are proprietary, to match the distribution of the more familiar FICO credit history scores, developed by Fair Isaac Corporation

agencies generally retain inquiry information for twenty-four months.

In aggregate, the Federal Reserve sample contained information on about 3.7 million credit accounts, more than 318,000 collection-related actions, roughly 65,000 monetary-related public record actions, and about 913,000 creditor inquiries. Not every individual had information of each type. In the sample, approximately 260,000, or 86 percent, of the individuals had records of credit accounts as of the date the sample was drawn (table 1).[19] Although a large portion of individuals had items indicating collection agency accounts, public record actions, or creditor inquiries, only a very small share (well less than 1 percent) of the individuals with credit records had only public record items or only records of creditor inquiries However, for about 12 percent of the individuals, the only items in their credit records were collection actions.

Credit History Scores in the Sample

The credit-reporting agency provided credit history scores for about 250,000, or 83 percent, of the individuals in the sample The agency used its proprietary credit-risk-scoring model as of the date the sample was drawn to generate the scores (one for each individual), which it constructed from selected factors of the type described previously. The proprietary credit-risk score is like other commonly used consumer credit history scores in that larger values indicate greater creditworthiness. The agency did not assign scores to anyone who did not have a credit account. A small proportion of individuals without scores did have credit accounts, but most of these individuals were not legally responsible for any debt owed.

To facilitate this discussion, we have adjusted the proprietary credit-risk scores assigned to individuals in the Federal Reserve sample to match the distribution of the more familiar FICO credit history scores, for which information is publicly available.[20] Among the individuals in our sample who had scores, about 60 percent had adjusted scores of 701 or above (chart 1) Individuals with FICO scores in this range are relatively good credit risks. According to Fair Isaac Corporation, less than 5 percent of such con-

19 The credit account information was provided by 92,000 reporters, 23,000 of which had reported within three months of the date the sample was drawn

20 For a national distribution of FICO scores, see www myfico com/myfico/creditcentral/scoringworks asp All three agencies use versions of the FICO score, which is generated from software developed by the Fair Isaac Corporation Each agency gives the score a different name Equifax calls it the Beacon score, Experian, the Experian/Fair Isaac Risk score, and Trans Union, the Empirica score In developing the scores, Fair Isaac used the same methods at each agency but estimated the FICO model differently at each one, using separate samples Thus, just as the information about an individual can differ across the three companies, so can the FICO model

sumers are likely to become seriously delinquent on any debt payment over the next two years[21] In contrast, about 13 percent of individuals in our sample had adjusted scores at or below 600. According to Fair Isaac, more than half of these consumers are likely to become seriously delinquent on a loan over the next two years.

Because credit history scores can be used to measure credit risk, creditors use them, along with other measures of creditworthiness, such as collateral, income, and employment information, to determine whether to extend credit and, if so, on what terms. Credit history scores are closely aligned with the interest rates offered on loans—that is, higher scores are associated with lower interest rates For example, as of August 30, 2004, the national average interest rate for a thirty-year fixed-rate conventional mortgage for an individual with a FICO score of 720 or more was 5.75 percent, whereas the average interest rate for someone with a score below 560 was 9 29 percent.[22]

Assessing the Effects of Data Limitations

The analysis to assess the potential effects of data limitations on an individual's access to credit involves two steps. identifying data problems in an individual's credit record and simulating the effects of "correcting" each problem on the availability or price of credit as represented by the change in the individual's credit history score To conduct this exercise, one must know (1) the factors used to construct the score, (2) the points assigned to these factors in deriving an individual's score, and (3) the process used to create the underlying factors from the original credit records.

The Federal Reserve's sample includes all the information that would be necessary to construct any credit history score and its underlying factors from the original credit records. However, the details of the credit-reporting agency's credit-scoring model, including the factors and point scales used in the model, are proprietary and were not made available to the Federal Reserve. Nevertheless, we were able to approximate the model by using three types of information: (1) the proprietary credit-risk score assigned to each individual in our sample, (2) a large set of credit factors for each individual—a subset of which was known to comprise the factors used in the proprietary credit-scoring model; and (3) detailed account-level information in each individual's credit record. We used the first two items to construct an approximation of the proprietary credit-scoring model, employing regression techniques to estimate the points to assign to each factor. We used the second and third items to "reverse-engineer" the credit factors included in our version of the credit-scoring model This information enabled us to recalculate how the factors—and ultimately the credit history scores—would change if alterations were made to the underlying credit records so that we could simulate the effects of correcting a data problem or omission.

Because of the numerous potential factors and specifications that could have been used to construct the proprietary credit-risk score, our version of the credit-scoring model undoubtedly differs from the actual proprietary model However, we were able to identify almost exactly the process used to construct the factors in the actual model from the underlying credit records. Moreover, the approximated and actual model scores corresponded quite closely. Thus, we believe that our approximation of the scoring process provides a reasonable estimate of the potential effects of a change in a credit record item on an individual's credit history score

Other model builders consider different credit-risk factors in creating their scoring models, assign different points to the factors, and employ different rules for constructing the factors. As a consequence, even if we had identified the proprietary model exactly, the results of our analysis would not necessarily have been the same as those implied by other models. Nevertheless, our results should be viewed as indicative of the implications of data quality issues for scoring models in general and as applicable in many, if not all, respects

DATA QUALITY ISSUES

As noted earlier, a previous article in this publication examined in detail the credit records of a sample of individuals as of June 30, 1999, and found that key aspects of the data were ambiguous, duplicative, or incomplete The article highlighted four areas of concern: (1) The current status of "stale" accounts, which show positive balances (amounts owed that are greater than zero) but are not currently reported, is ambiguous, (2) some creditors fail to report

21 The term "seriously delinquent" means falling behind on a loan payment ninety days or more, defaulting on a loan, or filing for bankruptcy

22 See www myfico com Loan rate includes 1 discount percentage point and is based on a loan amount of $150,000 for a single-family, owner-occupied property and on an 80 percent loan-to-value ratio As the data on the web site show, interest rates vary little by credit history score for individuals with scores above 700

credit account information, including nonderogatory accounts (accounts whose payments are being made as scheduled) or minor delinquencies (accounts 30 to 119 days in arrears); (3) credit limits are sometimes unreported; and (4) the reporting of data on collection agency accounts and public records may be inconsistent or may contain redundancies, and some of the items regarding creditor inquiries are often missing Our simulations, discussed below, address these areas of concern.

Ambiguous Status of Stale Accounts

A primary concern about data quality involves stale accounts About 29 percent of all accounts in the sample showed positive balances at their most recent reporting, but the report date was more than three months before the sample was drawn. These accounts fell into one of three categories based on their status when last reported. major derogatory (accounts that are 120 days or more in arrears and involve a payment plan, repossession, charge-off, collection action, bankruptcy, or foreclosure), minor delinquency, or paid as agreed Of all stale accounts with a positive balance at last report, about 15 percent were reported to be major derogatories, 3 percent were minor delinquencies, and 82 percent were paid as agreed.

Analysis of the credit records in the sample suggests that many of these stale accounts, particularly those involving mortgages and installment loans, were likely to have been closed or transferred but were not reported as such. Many were reported by creditors that were no longer reporting data to the agency about any individuals when the sample was drawn, and thus information on these accounts was unlikely to be up to date The significant fraction of positive-balance stale accounts that were likely closed or transferred implies that some consumers will show higher current balances and a larger number of open accounts than they actually hold.

Because the current status of stale accounts is often unclear, users of consumer credit reports must obtain additional information or make assumptions about the status. In credit-scoring models, such assumptions are inherent in "stale-account rules" that credit modelers typically apply when they calculate an individual's credit history score A stale-account rule defines the period for which reporting is considered current and thus identifies stale accounts. The rule also dictates how accounts identified as stale should be treated. In most cases, the rule treats them as closed accounts with zero balances

To some extent, rules that consider stale accounts closed and paid off may mitigate concerns about stale account information. Another possible mitigating factor is that consumers who review their credit reports for mistakes are likely to catch stale-account errors and to have them corrected Nevertheless, stale-account rules and consumer action can only partially correct the problem of noncurrent information in credit account records. For example, a rule that is conservative in identifying stale accounts may permit noncurrent information to be used over an extended period, whereas an overly aggressive rule may nullify information that is still current

Failure to Report Credit Account Information

Some reporters provide incomplete performance information on their accounts, and others fail to report any information about some credit accounts For example, in the Federal Reserve sample, 2.7 percent of the large creditors reported only credit accounts with payment problems.[23] The failure to report accounts in good standing likely affected the credit evaluations of consumers with such accounts. The way in which credit evaluations are affected depends on the circumstances of an account. For consumers with a low utilization of nonreported accounts, the failure to report may worsen their credit evaluations For consumers with a high utilization of nonreported accounts, however, the failure to report may result in better credit evaluations than are warranted.

In addition, some creditors report minor delinquent accounts as performing satisfactorily until the accounts become seriously delinquent. Almost 6 percent of the large creditors in the Federal Reserve sample followed this practice. Because the credit histories for consumers who fall behind in their payments to such lenders appear somewhat better in the credit records than they actually are, these consumers may benefit from such underreporting.

Finally, some lenders withhold account information For example, in 2003, Sallie Mae, the nation's largest provider of student loans, decided to withhold information on its accounts from two of the three credit-reporting agencies Clearly, while this policy was in effect, the failure to report information harmed some consumers and benefited others depending on

23 Some lenders, particularly those that specialize in lending to higher-risk individuals (referred to here as subprime lenders), choose to withhold positive performance information about their customers for competitive advantage

whether the withheld information was favorable or unfavorable

Unreported Credit Limits

A key factor that credit evaluators consider when they assess the creditworthiness of an individual is credit utilization If a creditor fails to report a credit limit for an account, credit evaluators must either ignore utilization or use a substitute measure such as the highest-balance level—that is, the largest amount ever owed on the account Substituting the highest-balance level for the credit limit generally results in a higher estimate of credit utilization because the highest-balance amount is typically lower than the credit limit; the higher estimate leads, in turn, to a higher perceived level of credit risk for affected consumers.

For the June 30, 1999, sample of individuals, proper utilization rates could not be calculated (the highest-balance levels had to be used) for about one-third of the open revolving accounts because the creditors had not reported the credit limits At that time, about 70 percent of the consumers in the sample had missing credit limits on one or more of their revolving accounts Circumstances have improved substantially since then because public and private efforts to encourage the reporting of credit limits have resulted in more-consistent reporting. Nevertheless, in the sample drawn as of June 30, 2003, credit limits were missing for about 14 percent of revolving accounts, and the omissions affected about 46 percent of the consumers in the sample. Thus, although the incidence of missing credit limits has fallen substantially, it remains an important data quality issue.

Problems with Collection Agency Accounts, Public Records, and Creditor Inquiries

Data on collection agency accounts, public records, and creditor inquiries are a source of inconsistency, redundancy, and missing information in credit records

Collection Agency Accounts

Evidence suggests that collection agencies handle claims in an inconsistent manner. Most notably, some collection agencies may report only larger collection amounts to credit-reporting agencies, whereas others may report claims of any size.[24] Inconsistent reporting does not imply inaccuracy of the information that does get reported, but it does imply some arbitrariness in the way individuals with collections are treated. Those whose collection items happen to be reported to the credit-reporting agency will have lower credit history scores than will those whose collection items go unreported. This situation raises the question as to the extent and effect of such arbitrary differences in treatment, particularly for small collection amounts. In addition, anecdotes abound about consumers who have had difficulty resolving disputes over collection items or who have had trouble removing erroneous items from their credit records.

Another potentially important data quality issue for collection agency accounts is duplication of accounts within collection agency records. Duplications can occur, for example, when a collection company transfers a claim to another collection company. Duplications can also occur when a debt in collection is satisfied but the paid collection is recorded as a separate line item by the collection agency Analysis of the collection agency accounts in the latest Federal Reserve sample suggests that about 5 percent of collection items are likely duplications resulting from such transfers or payouts

Credit evaluators also have some concern about the appropriateness of using medical collection items in credit evaluations because these items (1) are relatively more likely to be in dispute, (2) are inconsistently reported, (3) may be of questionable value in predicting future payment performance, or (4) raise issues of rights to privacy and fair treatment of the disabled or ill. The last concern recently received special attention with the inclusion of provisions in the FACT Act that address medical-related collections. One provision requires the credit-reporting agencies to restrict information that identifies the provider or the nature of medical services, products, or devices unless the agencies have a consumer's affirmative consent. In the future, the agencies may be able to meet this requirement by using a code, with the name of the creditor suppressed, to distinguish medical-related collections from other collections. Because the coding system is prospective, however, even if implemented today, years may pass before all the collection items in the agency files have this code. In the interim, if the name of the creditor is suppressed, distinguishing medical collection items

24 One indication of the inconsistent reporting of collection items is the wide dispersion across states in the ratio of small collection items to all collection agency accounts The percentage ranges from 30 percent to 60 percent

will depend on the ability of the credit-reporting agencies to mechanically code historical data. If such coding is done imperfectly, it may adversely affect consumers who deal with creditors that want to discount collection items involving medical incidents (As of September 2004, at least one of the agencies had developed a system that suppresses the name of the creditor and uses a code to distinguish medical-related collections.)

Public Records

Public records suffer from similar consistency and duplication problems that affect collection items. In particular, a single episode can result in one or more public record items depending on how it is recorded. For example, tax liens can be recorded on a consolidated basis or treated as separate items Similarly, amendments to a public record filing, such as a bankruptcy or a foreclosure, can be treated as updates, which result in no change in the number of items, or as new filings

In addition, evidence suggests that the credit-reporting agencies inconsistently gather information on lawsuits that the courts have not yet acted on, in part because some agency officials believe that the mere filing of a lawsuit does not necessarily relate to future credit performance For the most part, such lawsuits are missing from the public records. However, for idiosyncratic reasons, some lawsuits have been reported in nonrandom ways Specifically, 80 percent of the lawsuits in the Federal Reserve sample came from only two states, an indication that residents of these states may be at a disadvantage in credit evaluations.

About one-fourth of non-bankruptcy-related public records reflect dismissals In such cases, the courts seem to have determined that the individuals are not legally liable Such information may be of questionable value for credit evaluations

Creditor Inquiries

Although credit evaluators use information on creditor inquiries to predict future loan performance, the value of this information is limited in an important way. Ideally, credit evaluators would use such information to distinguish the consumers who are seeking multiple loans to greatly expand their borrowing from the consumers who are shopping for the best terms for a single loan However, the information that evaluators need to make this distinction—that is, a code that identifies the type of credit sought from the inquiring lender—is generally not available in inquiry records (it is missing from 99 percent of the inquiries in the Federal Reserve sample). Consequently, credit evaluators must use less reliable rules, potentially harming consumers who are simply shopping for a single loan by failing to distinguish them sufficiently from consumers who are seeking an excessive amount of credit

DESIGN OF THE SIMULATIONS

We designed a series of simulations to estimate the potential effects of the data quality issues identified in the preceding section Each simulation identified a set of "data problems" or potential problems, applied a plausible "correction" to each problem, and used an approximation of the proprietary credit-risk model to evaluate the effect of the correction on the credit history scores of individuals who had the problem in their credit records.[25] We estimated how many consumers each data problem affected; and for those who were affected, we estimated how many would see a decrease or an increase in their scores and by how much when the problem was corrected.

Selecting Factors in the Approximated Model

The first step in setting up the simulations was selecting the factors to be used in the approximated credit-scoring model The approximated model used seventy-three factors, including the number of credit accounts of different types and the various characterizations of payment history patterns, such as the number of accounts with all payments made on time, in various stages of delinquency, or with major derogatory status. Also included were measures of outstanding balances, credit limits on revolving accounts, ages of credit accounts, variables derived from collection agency accounts and public records, and account inquiry information Our discussions with credit evaluators suggested that most credit history models are based on a smaller number of factors than were included here. However, most of the "additional" variables in our model were decompositions or interactions that involved more general factors and were unlikely to lead to significant distortions in our representations of the effects of data quality issues.

25 We use the terms "data problem" and "correction" in their broadest sense For example, "data problem" may mean an actual problem or only a potential problem Similarly, "correction" may mean a solution to a problem or simply a "best guess" at a solution

2. Share of individuals with selected factors used in credit evaluation, distributed by type of account

Percent except as noted

Factor used in credit evaluation	Type of account			
	Revolving	Installment	Mortgage	Total
Number of credit accounts				
No account	3	26	55	0
1	13	16	14	9
2	7	12	11	5
3–5	18	22	16	12
6–8	16	11	3	11
9 or more	43	12	1	62
Total	100	100	100	100
Number of open credit accounts paid as agreed				
0	17	58	71	10
1	13	25	24	13
2	9	10	4	9
3–5	23	6	1	21
6–8	16	1	0	17
9 or more	22	0	0	30
Total	100	100	100	100
Number of credit accounts opened in most-recent 12 months[1]				
0	75	79	89	46
1	17	15	9	25
2 or more	8	6	2	29
Total	100	100	100	100
Years since most-recent credit account opened[1]				
0	26	26	55	0
Less than 1	22	20	10	51
1–2	23	25	11	29
3–4	10	13	7	9
5 or more	19	16	17	11
Total	100	100	100	100
Age of oldest credit account (years)[2]				
No oldest account	7	54	55	0
Less than 1	2	2	1	2
1–4	14	10	9	13
5–9	19	19	12	20
10 or more	58	15	22	65
Total	100	100	100	100
Amount owed on nonmortgage credit accounts (dollars)				
0	n.a.	n.a.		19
1–499	n.a.	n.a.		11
500–999	n.a.	n.a.		5
1,000–4,999	n.a.	n.a.	...	16
5,000–9,999	n.a.	n.a.	...	10
10,000 or more	n.a.	n.a.	...	39
Total	n.a.	n.a.		100
Utilization rate for revolving accounts (percent)[3]				
No account or not calculable	13	...	...	n.a.
0	24	...	...	n.a.
1–24	33			n.a.
25–49	11	...		n.a.
50 or more	19	...		n.a.
Total	100	...	...	n.a.
Share of individuals with credit accounts never delinquent				
0	n.a.	n.a.	n.a.	7
1–20	n.a.	n.a.	n.a.	2
21–60	n.a.	n.a.	n.a.	14
61–90	n.a.	n.a.	n.a.	21
91 or more	n.a.	n.a.	n.a.	56
Total	n.a.	n.a.	n.a.	100

Factor used in credit evaluation	Type of account			
	Revolving	Installment	Mortgage	Total
Number of credit accounts 30 days past due in past 12 months				
0	n.a.	n.a.	n.a.	75
1	n.a.	n.a.	n.a.	13
2	n.a.	n.a.	n.a.	5
3 or more	n.a.	n.a.	n.a.	7
Total	n.a.	n.a.	n.a.	100
Number of credit accounts 60 days past due in past 12 months				
0	n.a.	n.a.	n.a.	82
1	n.a.	n.a.	n.a.	10
2	n.a.	n.a.	n.a.	4
3 or more	n.a.	n.a.	n.a.	4
Total	n.a.	n.a.	n.a.	100
Number of credit accounts 90 days past due in past 12 months				
0	n.a.	n.a.	n.a.	86
1	n.a.	n.a.	n.a.	8
2	n.a.	n.a.	n.a.	3
3 or more	n.a.	n.a.	n.a.	3
Total	n.a.	n.a.	n.a.	100
Number of credit accounts more than 90 days past due				
0	n.a.	n.a.	n.a.	68
1	n.a.	n.a.	n.a.	11
2	n.a.	n.a.	n.a.	6
3 or more	n.a.	n.a.	n.a.	15
Total	n.a.	n.a.	n.a.	100
Worst delinquency ever on credit account (number of days delinquent)				
0	n.a.	n.a.	n.a.	51
30	n.a.	n.a.	n.a.	12
60	n.a.	n.a.	n.a.	5
90	n.a.	n.a.	n.a.	2
120	n.a.	n.a.	n.a.	4
More than 120	n.a.	n.a.	n.a.	26
Total	n.a.	n.a.	n.a.	100
Balance owed on collection accounts (dollars)				
No collection account or zero balance owed	...	...	...	73
1–99	...	...	...	2
100–499	...	...	...	9
500–999	...	...	...	5
1,000 or more	...	...	...	11
Total	...	...	...	100
Number of public records				
0	...	...	...	86
1	...	...	...	9
2 or more	...	...	...	5
Total	...	...	...	100
Number of creditor inquiries in past 6 months				
0	...	...	...	55
1	...	...	...	20
2	...	...	...	11
3	...	...	...	6
4 or more	...	...	...	8
Total	...	...	...	100

NOTE Data include only individuals with at least one credit account (of any type) and a credit history score

1 Data for revolving accounts include only bank-issued credit cards

2 Data for installment accounts include only bank-issued installment loans

3 Utilization rate is the proportion of available credit in use (outstanding balance divided by the credit limit—that is, the maximum amount an individual is authorized to borrow) The rate cannot be calculated in all cases because of unreported information on credit limit, highest balance, or outstanding balance

... Not applicable

n.a. Not available

We report many of the factors used in our model and show the distribution of individuals in the sample across each factor (table 2) For example, more than 60 percent of the individuals in the sample who had a record of a credit account had information on nine or more accounts, and more than half the individuals had opened at least one new account within twelve months of the date the sample was drawn. The patterns show that payment performance varies greatly among individuals: Although about two-thirds of individuals had never been more than ninety days past due on a credit account, 15 percent had been this late on three or more accounts. In addition, nearly 15 percent had a record of at least one bankruptcy, tax lien, or other monetary-related public action, each of which weighs heavily in credit evaluations

Estimating the Approximated Model

To estimate our approximation of the proprietary credit-scoring model, we used standard statistical regression techniques to fit the actual proprietary credit-risk score against the selected credit factors for the individuals in the sample data. Although credit modelers typically break factors into ranges, because we did not know the break points that had been selected, we approximated the process with linear splines.[26] For the estimation, the sample included only individuals with proprietary credit-risk scores who had not filed for bankruptcy. Our simulations were also restricted to this sample.[27]

We estimated the regression equation separately for three subpopulations The first group consisted of individuals with one or more major derogatory credit accounts in their credit records. Both the second and third groups consisted of individuals who had no major derogatory accounts, but individuals in the second group had no more than two credit accounts whereas those in the third group had more than two credit accounts. We conducted the analysis in this way because allowing the estimated coefficients to differ across population subgroups provided a noticeably better fit. The approach was also consistent with the common industry practice of using different "scorecards" for different subpopulations. The R^2 (a statistic characterizing how well a model fits the data) for each of the three subpopulation regressions was about 0 85, and the combined R^2 for the full population was about 0 94

Proprietary considerations constrain our ability to report details of the regression equation specification or the coefficient estimates. However, a few variables in the estimated credit-scoring model were statistically insignificant and sometimes exhibited an unexpected relationship to the credit history score As a consequence, as will be seen below, simulations of the effects of changes in an individual's credit record led in a few instances to anomalous outcomes in the sense that some scores moved in unexpected directions when changes in the individual's credit record were simulated.

Conducting the Simulations

As noted, the simulations identified problems in the data and applied hypothetical corrections to them. Only in the case of missing credit limits, however, could we identify the problem unambiguously. In other cases—specifically, stale accounts and the data quality issues associated with collections, public records, and inquiries—we could determine only that the information was *likely* inaccurate, incomplete, or of questionable value [28] Finally, in other situations, a data problem was unobservable, such as when accounts were unreported or inconsistently reported. In these situations, we could identify only the potential effect on credit history scores of correcting the problem but not the proportion of people affected

We conducted fifteen simulations: three that addressed issues related to stale credit accounts, four that pertained to nonreported credit account information, and eight that addressed data quality issues for collection agency accounts, public record items, and creditor inquiries

Stale Accounts Last Reported as Paid as Agreed or as Minor Delinquencies

Recognizing the prevalence of stale accounts in credit records, most credit-scoring modelers apply stale-

26 The use of linear approximations rather than ranges is likely to mean that our simulations implied more small but consistent changes in credit history scores when factors were altered than would the "true" model, which divides consumers into two groups those whose scores did not change because they stayed within the same range and those whose scores changed more substantially because they moved to a different range

27 Although individuals who had filed for bankruptcy or did not have a proprietary credit-risk score were excluded from our analysis, these individuals may also have been affected by data quality problems However, because they had not been scored or they had filed for bankruptcy, they were likely subject to a different type of credit review process, one that may have provided greater opportunities for the loan underwriter to identify and address data quality problems

28 In the case of stale accounts, the information was clearly outdated In the case of inquiries, the information was incomplete in that we could not determine whether the inquiries were associated with shopping for a single loan

account rules to such accounts when they develop credit evaluation models For credit accounts that have never been in major derogatory status (paid-as-agreed accounts or accounts with only minor delinquencies recorded), the rules typically retain the historic information on payment performance but dictate that certain accounts that have gone unreported for an extended period no longer have balances outstanding. Any balances shown at last report for these accounts are reset to zero.

In reverse-engineering the factors used in this analysis, we discovered that the credit-reporting agency had imposed a one-year stale-account rule when it created most factors related to paid-as-agreed accounts and to accounts with only minor delinquencies. Our simulation examined the effects on these accounts of a more-aggressive stale-account rule, one that redefined stale accounts on the basis of a three-month period for current reporting [29]

Stale Accounts with Major Derogatories

Some stale accounts were last reported in major derogatory status Here the payment status was more likely to have remained the same since the last report than it was in the case of stale accounts that were paid as agreed or showed only minor delinquencies at last report Many seriously delinquent accounts can remain in that state for an extended period with no change in status (and thus the account information need not be updated) However, in several situations, the reported account status is likely to be no longer accurate, such as when a consumer has taken out a new mortgage after the date on which the stale major derogatory was last reported Generally, a mortgage lender will not extend a new loan until a consumer pays off (or otherwise addresses) all major derogatories Another situation in which the reported account status is likely to be inaccurate is when the account creditor no longer reports about any individuals. In this case, the account has probably been paid off or transferred.

We evaluated the effect of non-updating of credit account information in these situations by treating as paid off all stale major derogatories for which (1) the consumer had taken out a new mortgage after the date on which the major derogatory was last reported or (2) the creditor for the derogatory account had not reported information on any consumer within three months of the date on which the sample was drawn The credit-reporting agency had imposed a one-year stale-account rule when it created factors related to major derogatory accounts. The rule implied that paying off a major derogatory account that had not been reported within a year generally would have no effect on an individual's credit history score. Thus, we again restricted our analysis of the effect of stale accounts to those that had last been reported three to twelve months before the date on which the sample was drawn

Failure of Some Subprime Creditors to Report Accounts

As a potential source of data inaccuracy, the failure of some subprime creditors (lenders that specialize in loans for high-risk individuals) to report accounts differs from the others studied here in that nonreporting is by definition unobservable. Consequently, the task for researchers is conceptually more difficult, and simulations cannot address the incidence of such nonreporting. To simulate the potential effect of such creditor behavior, we chose a random, never-delinquent mortgage, installment, or revolving account at a subprime lender for each individual with such an account and rescored the individual as if the account had not been reported We defined subprime lenders as those that were reporting credit accounts as of the date the sample was drawn and for which more than one-half of their customers in the sample had credit history scores in the high-risk range (a score below 600).

Failure of the Largest Student Loan Creditor to Report Any Accounts

As noted above, in 2003 Sallie Mae stopped reporting information on its accounts to two of the three largest credit-reporting agencies. Moreover, Sallie Mae asked that the agencies suppress all historic information on the accounts it had previously reported. By the time the Federal Reserve sample was drawn, Sallie Mae had reversed its initial decision. Our sample omits information that would allow us to identify Sallie Mae specifically Thus, to approximate the potential effect of Sallie Mae's original decision, we deleted information on the loans of random student-loan lenders—representing approximately the same number of student loans that Sallie

29 Analysis of the patterns of verification showed that the vast majority of open accounts were verified by the reporter every month or two Thus, in choosing a three-month rule, we simulated the effect of a maximally aggressive stale-account rule on the likely inaccuracy associated with the account information We had no obvious way of simulating the effect of lengthening the time period

Mae stopped reporting—from the credit records in the Federal Reserve sample, and we rescored the affected individuals

Failure of Some Creditors to Report Minor Delinquencies

Our review of the sample indicates that a small percentage of lenders fail to report that paid-as-agreed accounts have become minor delinquencies Rather, the lenders report the accounts as paid as agreed until the accounts become major derogatories To simulate the potential effects of unreported minor delinquencies, for each individual we randomly selected a currently reported account that was not in major derogatory status, was associated with a lender that did report minor delinquencies for each individual, and had been thirty or sixty days delinquent at least once. We assigned "paying as agreed" performance status to each thirty- and sixty-day delinquency in the selected account's performance record. This adjustment replicates what the credit record would show for a lender that reported thirty- and sixty-day minor delinquencies to be paid as agreed.

Failure of Some Creditors to Report Credit Limits on Revolving Accounts

As noted, about 14 percent of revolving credit accounts were reported without information about credit limits, affecting roughly 46 percent of the individuals in the Federal Reserve sample. Therefore, credit evaluators must use other means to derive credit utilization rates for these individuals The most common approach (and the one that model developers customarily use for credit-risk factors) is to substitute the highest balance for the missing credit limit; the typical result is higher calculated utilization rates than if the credit limits had been reported

We simulated the effects of the nonreporting of credit limits on individuals by creating an estimated credit limit for each revolving account without a reported limit Because information on the true credit limit in these cases was missing, the simulation in effect compared our method of calculating credit utilization rates with that of the credit-reporting agency. The primary difference between the two estimation procedures is that our approach is statistically unbiased, whereas the agency's method, which relies on the highest-balance amount, tends to be biased upward That is, our estimates reflect the "best guess" for the missing credit limit based on other information in the individual's credit record Specifically, we used samples of accounts of individuals with reported credit limits to estimate a regression model that predicted the credit limits for revolving accounts with missing limits [30]

Duplications in Collection Agency Accounts

A review of the sample credit records suggests that some collection agency accounts may be duplicated. Duplication can occur because of changed account numbers or transfers of accounts from one collection agency to another. To address the potential effects of this problem, we conducted simulations that consolidated likely duplicated collection account records into single items We identified simulated duplicates in two ways One procedure was to match the collection amount and the identity of the creditor when one account was reported paid and the other unpaid The second procedure was to identify likely account transfers that were not reported as such to the credit-reporting agencies

Additional duplicate collection agency accounts likely exist in the data but are difficult to identify For example, accounts that match on collection amount and identity of the original creditor but that are reported by a single agency with reporting dates that are close in time may be duplicates, but they may just as likely result from repeated missed payments of the same amount. Accounts that match on identity of the original creditor and are spaced apart in time but do not match on amount could indicate a new report filed after a partial payment was received, in which case they would involve duplication. Alternatively, they could reflect separate incidents of missed payments with the same creditor.

Inconsistent Reporting of Small Collection Agency Accounts

Analysis of collection accounts reveals that many are for very small amounts that may be inconsistently reported. Recognizing this possibility, some credit evaluators choose to exclude small collection accounts from credit evaluations To test the effect of inconsistently reported small collection items on

30 Independent factors used in the estimation included outstanding balance and highest-balance level, the age and type of account, the type of lender, balances and limits on other accounts, and payment performance information The resulting distribution of estimated credit limits and utilization for accounts with imputed limits was virtually identical to the distribution of accounts with reported limits within the population, an indication that missing limits are primarily a function of the lender and are almost always unrelated to the characteristics of the account

credit history scores, we removed all collection records involving items under $100 from the credit records.

Medical Collection Items

Some credit evaluators report that they remove collection accounts related to medical services from credit evaluations because such accounts often involve disputes with insurance companies over liability for the accounts or because the accounts may not indicate future performance on loans. Unfortunately, evaluators must use manual overrides based on the creditors' identities to remove medical collection accounts because the credit record data lack a code identifying claims associated with medical services. The absence of a code means that this process cannot be used in automated calculations of credit history scores. To test the potential effect of including medical collection items in the calculation of credit history scores, we developed a medical collection code based on an inspection of the creditor name, and we used the code to identify medical collection accounts to drop from the credit history score calculation (as noted earlier, as of this writing, at least one of the agencies had developed such a code, potentially reducing the relevance of this simulation).

Potentially Misassigned Collection Agency Accounts

Most (72 percent) of the individuals in the sample with a non-credit-related collection agency account also had a credit-related major derogatory. About 45 percent of those individuals with information reported by a single collection agency had no credit-related major derogatories. In contrast, only about 15 percent of those with information reported by more than one collection agency had no credit-related major derogatories. These patterns suggest that misassigned collection agency accounts may be more common among those with information reported by a single collection agency. We simulated the effects of correcting such misassigned collections by dropping the collection accounts of individuals who had information reported by one collection agency but had no credit-related major derogatories.

Duplications in Public Records

As with our analysis of collection agency accounts, our review of the sample public record reports suggests that some records may be duplicated. To address the potential effects of this problem, we conducted simulations that removed likely duplicates of public record items. We identified duplicates by matches on the recording date, amount owed, and creditor. In many instances, the duplicates involved the original filing of a judgment or lien, which was followed by a record of a paid judgment or lien with all information identical to that in the first record. In other instances, second or third filings may have ended up as duplicates with the same (or almost identical) information.

Inconsistent Reporting of Lawsuits and Dismissed Items in Public Records

As noted earlier, our analysis of credit record files in the Federal Reserve sample suggests that lawsuits are inconsistently included in the credit-reporting agency files. An additional issue concerns the inclusion in the public records of dismissed liens, judgments, or suits, which may be of questionable value for predicting credit performance. To simulate the potential effects of including these items in the calculation of credit history scores, we removed all lawsuits and dismissals from the credit records of individuals with such items.

Failure to Consolidate Multiple Inquiries for the Same Loan

Analysts have cautioned that simple counts of inquiries in scoring models may unfairly penalize consumers who shop for credit. However, the information needed to help distinguish consumers shopping to obtain a single loan from those seeking to obtain multiple loans is generally not available in credit records because of incomplete reporting of the type of inquiry.

To simulate the potential magnitude of the effect of incomplete reporting of the type of inquiry, we conducted two experiments. First, we identified all individuals in the sample who had taken out a mortgage or an auto loan in the two years before the sample was drawn. For each loan type, we consolidated into a single inquiry the multiple inquiries that had occurred in the two-month period preceding the date on which the loan was opened (if any non-auto or non-mortgage loans were also taken out during this period, we did not consolidate any inquiries). The second simulation was somewhat broader. We divided all inquiries into three groups based on the type of inquirer as a proxy for the likelihood that

the consumer was shopping for a single loan or potentially "bulking up on credit." The first group represented inquiries that were unlikely to be credit-related, including inquiries from insurance companies, utilities, and collection agencies. The second group involved inquiries likely related to the purchase of a single large item, such as inquiries from auto companies or real estate firms. We put all other inquiries in the third group. Inquiries from the first group were dropped in the simulation because they did not appear to be credit related. For the second group, we consolidated all inquiries within a two-week period into a single inquiry. Only inquiries from the third group were left unchanged.

Analyzing the Populations of Interest

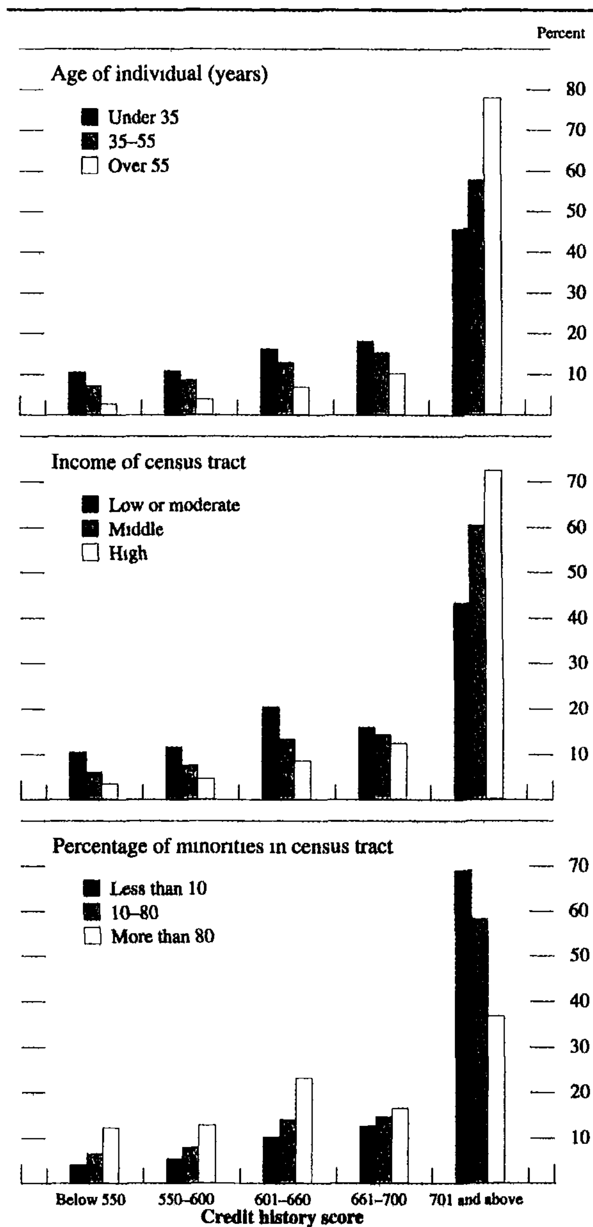
Each of the data quality issues that we focus on may have different implications for different individuals depending on the individuals' credit characteristics. For example, the effect of a missing credit limit will be different for individuals who have many open revolving accounts than for those who have few. Therefore, we also examined the effect of these data quality issues for three subpopulations of interest. Because data quality problems are less likely to affect the access to credit of individuals with relatively high credit history scores, we divided the analysis population (the same one used to estimate the approximated model) into categories based on credit history score. We also categorized the analysis population by depth of credit file and by selected demographic characteristics.

For the analysis by credit history scores, we sorted individuals into one of three risk groups based on their proprietary credit-risk scores. The first group included individuals whose scores were 661 or above (74 percent of the sample population), the second group included individuals with scores between 600 and 660 (13 percent of the sample), and the third group included individuals whose scores were below 600 (13 percent of the sample).[31]

31 Individuals with credit scores above 660 have scores sufficiently high that they are likely to qualify for the lowest interest rates available on loans, and individuals with scores below 600 have scores sufficiently low that they are likely to be denied credit or to pay substantially higher rates than those charged to better-qualified borrowers. Individuals in the middle category have scores that place them at the margin.

The credit history score ranges used here are not immutable; in practice, the bounds of these ranges vary somewhat by loan product and by the appetite for risk of individual market participants. Moreover, credit history is only one factor considered in credit underwriting, although an important one, and so a low credit history score may be offset by, for example, a low debt-to-income ratio, a significant down payment, collateral, or potential for strong future earnings.

2. Distribution of individuals, by credit history score and by selected demographic characteristics



NOTE. See note to chart 1. Income categories are defined as follows: *low or moderate*, less than 80 percent of the median family income of individual's metropolitan statistical area (MSA) or of nonmetropolitan portion of individual's state; *middle*, 80–119 percent of the median family income of individual's MSA or of nonmetropolitan portion of individual's state; *high*, 120 percent or more of the median family income of individual's MSA or of nonmetropolitan portion of individual's state.

For the analysis by depth of credit file, we sorted individuals with records of credit accounts into two groups based on the number of credit accounts in their credit records. One group consisted of individuals with "thin files"—that is, files with fewer than four credit accounts. The second group consisted of all other individuals. Individuals with thin files, who

accounted for about 19 percent of the sample, are an important segment of the population to examine because their credit history scores may exhibit relatively greater sensitivity to data problems. A data problem affecting a particular account may be more likely to have a substantial effect on the credit history score of an individual with a thin file because of a lack of information from other accounts that could dilute the effect of the problem.

For the other analyses, we investigated whether different patterns emerge when individuals are grouped by age, relative income of census tract of residence, and percentage of minorities in census tract of residence. Such segmentation allows us to determine whether issues of data accuracy and completeness likely affect various subgroups of the population in different ways. For example, residents of higher-income census tracts may, on average, have more revolving accounts than residents of lower-income areas and therefore may face a greater probability of encountering a missing credit limit. We report the distribution of proprietary credit-risk scores for these various subgroups (chart 2).[32] In general, younger individuals, those who live in lower-income areas, and those who live in areas with high minority populations have lower scores.

RESULTS

First, we report the proportion of individuals who are affected by a simulated change in (correction to) the credit records—that is, the proportion subject to the data quality issue in question (table 3). Second, we report the proportion among those affected by the simulated change in credit records for which the net effect on approximated credit history scores was zero. Third, we report the proportions of individuals among those affected by the simulated change for which approximated credit history scores changed

32. Scores in chart 2 are somewhat higher than scores for individuals in the simulation samples, which exclude individuals who have had bankruptcies.

3. Estimated effects of data "corrections" on the credit history scores of individuals, by data problem corrected

Percent except as noted

Data problem corrected	Individuals affected	Distribution of individuals affected						Memo	
		Effect on credit history score					Total	Mean change in points	
		No change	Decrease		Increase			Individuals with decrease in score	Individuals with increase in score
			1–9 points	10 or more points	1–9 points	10 or more points			
Involving credit accounts									
Failure to close a									
Paid-as-agreed account	12.9	10.9	27.0	8.1	48.7	5.2	100.0	–8.1	4.4
Minor delinquent account	1.3	4.5	20.0	17.8	43.1	14.5	100.0	–12.6	8.6
Major derogatory account	4.7	82.3	9.2	3	8.2	0	100.0	–1.9	1.2
Failure of a subprime lender to report a paid-as-agreed account	n.c.	28.5	41.0	8.9	17.9	3.7	100.0	–6.0	6.2
Failure of largest student loan creditor to report	3.5	16.1	45.0	13.1	21.5	4.4	100.0	–7.0	7.5
Failure to report a									
Minor delinquency	n.c.	15.1	39.3	20.8	22.4	2.4	100.0	–11.0	4.0
Credit limit	33.0	31.7	1.7	0	53.3	13.3	100.0	–1.4	6.1
Involving collection agency accounts									
Failure to eliminate duplicate collection agency accounts	1.2	6.8	1.1	0	67.4	24.7	100.0	–1.4	8.5
Reporting of									
Collection agency accounts under $100	11.1	41.2	7.0	1.2	41.7	8.9	100.0	–4.3	5.8
Medical collection accounts	15.5	11.8	5.4	1.5	49.6	31.6	100.0	–5.9	11.2
Potentially misassigned collection accounts	8.2	12.8	9.0	3.4	42.8	31.9	100.0	–6.9	13.4
Involving public records									
Reporting of duplicate public records	4	38.6	1.9	0	59.4	1	100.0	–1.9	1.3
Inclusion of lawsuits and dismissals	1.1	18.5	3.8	1.0	53.1	23.6	100.0	–5.9	9.1
Involving creditor inquiries									
Failure to consolidate									
Multiple inquiries for auto and mortgage loans	3.7	16.8	8.3	5	73.8	7	100.0	–2.9	2.3
Other multiple inquiries	14.6	5.2	4.9	1	85.4	4.4	100.0	–2.3	4.2

NOTE. The table reports the effect of "correcting" a data problem. Individuals whose scores increase because of a correction would be better off if the problem were corrected.

n.c. Not calculable.

materially—that is, increased or decreased 10 or more points. These calculations provide insight into the proportion of consumers who may or may not face a change in credit terms (either a higher or a lower interest rate) or who may be unable to gain access to credit because of the particular data problem. Also, to provide another basis for determining how much variation in credit history scores may occur when simulated corrections are made to individuals' credit records, we present the overall mean change in credit history scores for the individuals who were materially affected Because the hypothesized correction may increase or decrease an individual's credit history score depending on the nature of the problem and the composition of the individual's credit record, the mean change for individuals with a decrease in score and the mean change for those with an increase in score are shown separately

For each simulation, the overall effect of a simulated change on an individual can be either positive or negative. Some of the effect is undoubtedly due to imprecision in our approximation of the credit-scoring model or to consumers' being shifted from one "scorecard" to another. However, we believe the results mainly reflect the complexity of interactions among the various factors that produce a credit history score. For example, a failure to report a paid-as-agreed account as closed can help individuals with few active and paid-as-agreed credit accounts but can hurt individuals with a substantial number of accounts that have high balances and utilization rates.

Effects of Stale Accounts

The first group of simulations presented in the table involved hypothetical corrections to selected credit account records The first three of these pertained to the use of a more aggressive stale-account rule that designated accounts as stale after three months of nonreporting and treated the accounts as being closed and having a zero balance. Several conclusions emerged from these simulations. On the one hand, a significant proportion of consumers appeared to be subject to stale credit account issues Almost one-fifth of the individuals in the Federal Reserve sample had at least one stale credit account as defined by the assumptions of the first three simulations. Further, 21 percent of the individuals with stale major derogatories (percentage not shown in table) had at least one account that met the conditions of the third simulation and thus had potentially been paid off.

On the other hand, the application of the more aggressive stale-account rule appeared to have only a modest effect on the credit history scores of these individuals Our simulations suggest that more than 80 percent of the individuals with stale major derogatories would have shown no change in score if they had paid off the account the month after the date on which the lender last reported it and the lender had reported the payoff to the credit-reporting agency. The effect of paying off accounts was somewhat larger for paid-as-agreed accounts and for those with minor delinquencies, but even here most consumers showed changes of fewer than 10 points. One likely explanation for the relatively minor effect of the corrections on individuals is the large number of credit accounts in the typical consumer's file For example, consumers with a stale paid-as-agreed account had, on average, almost sixteen credit accounts, and 90 percent of these consumers had at least five

Many of the credit-risk factors reflect "extreme" values such as the age of the oldest account or the number of months since the most-recent delinquency. These factors will change as the result of a correction only if the affected account is the "marginal" account—for example, the oldest or the most recently delinquent. Moreover, although factors reflecting sums, such as total balances, will be sensitive to changes in any account, the effect of the change will be reduced if many other accounts contribute to the factor. Another explanation for the relatively minor effects of the corrections for stale accounts probably lies in the rules used to calculate the factors employed by credit modelers For example, modelers appear to place little weight on outstanding balances for major derogatory accounts, perhaps recognizing the inconsistency in the reporting of account payoffs Thus, when payoffs are recorded, the effect on scores is minimal.

Effects of Unreported Credit Account Information

We conducted an additional four simulations for data problems in credit accounts. The simulations addressed the nonreporting of certain categories of accounts (paid-as-agreed accounts of a subprime lender and accounts of the largest student loan creditor) and of certain types of information (minor delinquencies and credit limits)

We could not determine the incidence of subprime creditors' failure to report paid-as-agreed credit accounts. By our estimates, Sallie Mae's failure to report loans affected less than 4 percent of individuals. Nonreporting of these types of accounts appeared

4 Estimated effects of data "corrections" on the credit history scores of individuals, by data problem corrected, for selected credit history score ranges

Percent except as noted

Data problem corrected	Individuals affected	Distribution of individuals affected						Memo	
		Effect on credit history score					Total	Mean change in points	
		No change	Decrease		Increase			Individuals with decrease in score	Individuals with increase in score
			1–9 points	10 or more points	1–9 points	10 or more points			
	Individuals with credit history scores above 660								
Involving credit accounts									
Failure to close a									
Paid-as-agreed account	13.6	11.3	22.0	4.7	55.8	6.2	100.0	–6.1	4.5
Minor delinquent account	2	3.1	19.2	52.9	21.7	3.1	100.0	–20.2	5.0
Major derogatory account	1.2	89.1	6.1	.2	4.6	.0	100.0	–1.8	1.0
Failure of a subprime lender to report a paid-as-agreed account	n.c	45.5	30.1	2.8	20.3	1.3	100.0	–4.3	3.0
Failure of largest student loan creditor to report	3.2	19.3	50.4	9.7	19.3	1.3	100.0	–6.1	3.8
Failure to report a									
Minor delinquency	n.c.	19.6	45.7	20.0	14.2	.6	100.0	–9.3	3.0
Credit limit	35.8	34.8	1.4	0	54.1	9.7	100.0	–1.1	5.1
Involving collection agency accounts									
Failure to eliminate duplicate collection agency accounts	.1	11.7	4	0	81.4	6.6	100.0	–1.0	4.6
Reporting of									
Collection agency accounts under $100	3.6	21.8	9.3	2.7	42.8	23.4	100.0	–5.8	10.6
Medical collection accounts	6.5	5.2	8.0	2.9	35.7	48.3	100.0	–6.8	16.6
Potentially misassigned collection accounts	5.4	4.7	11.0	4.4	31.4	48.6	100.0	–1.6	6.4
Involving public records									
Reporting of duplicate public records	2	39.1	2.3	.0	58.6	.0	100.0	–1.0	1.1
Inclusion of lawsuits and dismissals	.7	19.2	5.0	1.7	45.5	28.7	100.0	–7.0	10.8
Involving creditor inquiries									
Failure to consolidate									
Multiple inquiries for auto and mortgage loans	3.4	10.9	3.8	0	84.7	7	100.0	–1.6	2.3
Other multiple inquiries	12.2	3.1	1.4	0	94.0	1.5	100.0	–1.4	3.6
	Individuals with credit history scores between 600 and 660								
Involving credit accounts									
Failure to close a									
Paid-as-agreed account	12.1	11.0	49.4	13.0	25.4	1.3	100.0	–6.4	3.3
Minor delinquent account	2.6	4.0	27.2	22.6	41.7	4.6	100.0	–11.9	4.9
Major derogatory account	10.2	87.9	6.4	1	5.7	0	100.0	–1.7	1.3
Failure of a subprime lender to report a paid-as-agreed account	n.c	22.2	48.6	6.4	19.4	3.5	100.0	–4.2	4.9
Failure of largest student loan creditor to report	3.8	8.1	33.7	17.6	33.0	7.6	100.0	–9.5	6.0
Failure to report a									
Minor delinquency	n.c.	11.0	33.1	21.5	31.2	3.2	100.0	–11.7	3.7
Credit limit	28.4	14.4	2.3	.0	57.2	26.1	100.0	–1.8	7.8
Involving collection agency accounts									
Failure to eliminate duplicate collection agency accounts	3.0	8.6	.8	.0	80.7	9.9	100.0	–1.0	5.3
Reporting of									
Collection agency accounts under $100	28.1	43.6	5.7	1.2	42.7	6.9	100.0	–5.1	4.4
Medical collection accounts	38.8	11.1	4.4	1.7	56.5	26.4	100.0	–7.2	9.2
Potentially misassigned collection accounts	11.8	18.1	9.7	6.9	48.1	17.2	100.0	–9.8	9.6
Involving public records									
Reporting of duplicate public records	7	44.3	1.0	0	54.7	0	100.0	–1.0	1.1
Inclusion of lawsuits and dismissals	2.1	20.8	2.2	.2	62.2	14.7	100.0	–4.2	6.4
Involving creditor inquiries									
Failure to consolidate									
Multiple inquiries for auto and mortgage loans	5.0	32.7	15.1	1	51.6	6	100.0	–1.9	2.0
Other multiple inquiries	17.0	10.0	7.8	.0	80.9	1.3	100.0	–1.5	3.9

4 —Continued

Data problem corrected	Individuals affected	Distribution of individuals affected						Memo	
		Effect on credit history score					Total	Mean change in points	
		No change	Decrease		Increase			Individuals with decrease in score	Individuals with increase in score
			1–9 points	10 or more points	1–9 points	10 or more points			
	Individuals with credit history scores below 600								
Involving credit accounts									
Failure to close a									
Paid-as-agreed account	9 1	7.0	46.0	35.8	10.4	.8	100.0	−16.8	3.3
Minor delinquent account	7.1	5.0	17.3	9.9	47.4	20.4	100.0	−9.9	9.8
Major derogatory account	22.9	77.3	11.7	.4	10.6	.1	100.0	−2.0	1.3
Failure of a subprime lender to report a paid-as-agreed account	n c	7.2	52.4	19.8	13.1	7.6	100.0	−8.1	12.4
Failure of largest student loan creditor to report	4.8	8 5	30.0	24.7	21.3	15.7	100.0	−13.1	16.1
Failure to report a									
Minor delinquency	n c.	5.8	26.0	22.7	38.5	7.0	100.0	−17.0	3.3
Credit limit	19.3	19 9	4.2	.1	37.7	38.1	100.0	−1.9	13.1
Involving collection agency accounts									
Failure to eliminate duplicate collection agency accounts	6 8	5.2	1.4	.0	58.9	34.6	100.0	−1.5	10.6
Reporting of									
Collection agency accounts under $100	43 2	50.7	6 7	.3	40.4	2.0	100.0	−2.4	2.6
Medical collection accounts	51.6	18.0	4.1	.2	55.9	21.7	100.0	−2.7	8.0
Potentially misassigned collection accounts	23.5	22.6	5.7	.1	57.8	13.9	100.0	−1.6	6.4
Involving public records									
Reporting of duplicate public records	1 0	34.1	1 8	.0	63.7	.4	100.0	−3.4	1.8
Inclusion of lawsuits and dismissals	2 6	15 1	3 1	.3	59.8	21.7	100.0	−2.5	8.5
Involving creditor inquiries									
Failure to consolidate									
Multiple inquiries for auto and mortgage loans	4 3	27.7	23.5	3.7	44.4	.8	100.0	−4.6	2.2
Other multiple inquiries	28.2	8.5	13 1	6	62.9	14.9	100.0	−2.9	6.5

NOTE See note to table 3

n c Not calculable

to have only a modest effect on the credit history scores of affected individuals. For example, the simulation results indicate that if nonreporting by a subprime lender or by Sallie Mae had been corrected, in each case less than 5 percent of affected individuals would have gained 10 percentage points or more in their credit history scores. Moreover, such nonreporting may help or hurt the individuals. For example, the simulations suggest that, on average, consumers were helped by Sallie Mae's not reporting their loans, a somewhat surprising result. Fifty-eight percent of affected individuals would have experienced decreases in their credit history scores if the accounts had been reported. However, the median number of credit accounts for individuals with a corrected student loan account was twenty-two, a figure well above average for all individuals. Thus, the positive effects on credit history scores of reducing individuals' outstanding balances by not reporting their student loans may have outweighed the negative effects of eliminating one additional paid-as-agreed account.

We also could not determine the proportion of individuals affected by creditors' suppression of minor delinquencies; however, we could estimate the impact of the suppression on affected individuals. The simulation suggests that when suppression occurs, it is likely to improve the credit history scores of many affected individuals by a significant amount.

Effects of Unreported Credit Limits

Nonreporting of credit limits affects a substantial number of individuals (33 percent of the individuals

in the simulations), but the effect tends to be small. The likely reason for this result is that affected individuals tend to have a large number of credit accounts in their credit records (eighteen on average), while the frequency of accounts missing limits is low. Thus, accounts with missing limits tend to have a small effect on the overall utilization rates of individuals.

Unlike the results in most of the other simulations, the effects of missing credit limits were predominantly in one direction—most affected individuals' scores would have likely been higher if missing credit limits had been reported. This finding suggests that the rule that credit modelers typically adopt for addressing missing limits—use of the reported highest-balance amount—is likely biased. To further test this conjecture, we examined credit accounts for which the credit limit was reported and compared the actual limit with the estimated limit that credit modelers would have applied if the limit had not been reported. On average, the rule that the credit-reporting agencies used when they constructed utilization rates would imply a credit limit of less than one-half the actual limit. The rule would imply a lower credit limit than the actual limit in about 90 percent of the cases. In contrast, our rule, as noted earlier, was statistically unbiased.

Effects of Problems with Collection Agency Accounts, Public Records, and Creditor Inquiries

Results for eight simulations involving collection agency accounts, public records, and creditor inquiries were varied.

Collection Agency Accounts

The proportion of individuals affected by potential data problems or inconsistencies in reporting by collection agencies ranged from 16 percent for reporting of medical collection items to only about 1 percent for duplication of collection items, although, as noted, our ability to detect such duplications was limited. However, the effect of corrections on affected individuals tended to be large, particularly in comparison with simulated problems in credit accounts, and was generally associated with increases in credit history scores. For example, for three of the four collection account simulations, one-fourth or more of the affected individuals showed increases of 10 points or more in their scores. These results illustrate that collection accounts weigh heavily in the scoring model and that most individuals have relatively few such accounts and thus are affected more significantly when a problem occurs in any given account.

Public Records

Both simulations that addressed potential data problems or inconsistencies in public records indicated that the proportion of individuals affected was small (1 percent or less). However, the effects of the corrections differed significantly between the two simulations. In the simulation involving duplicate public record items, less than 1 percent of affected individuals experienced increases in their credit history scores of 10 points or more, whereas in the simulation involving lawsuits and dismissals, nearly one-fourth of affected individuals did so. This dichotomy reflects an important distinction between duplicate public records and lawsuits and dismissals. Whereas removing a lawsuit or a dismissal may completely eliminate adverse public record items from an individual's credit record, eliminating a duplicate record cannot do so.

Creditor Inquiries

The simulation that consolidated inquiries related to auto and mortgage loans affected only 4 percent of individuals in the sample; the broader consolidation simulation affected about 15 percent of individuals. In both cases, the size of the effect was modest and almost always resulted in a higher score. Only a small percentage of individuals experienced increases in their scores of more than 10 points.

Differences across Subpopulations

Individuals with scores below 600 tended to have the highest frequency of data problems, and those with scores above 660 had the lowest incidence (table 4). Two exceptions to this pattern occurred in the simulations involving the failure to close stale paid-as-agreed accounts and the failure to report a credit limit. Here individuals in the highest score range showed the largest incidence of data problems primarily because they tended to have more credit accounts. Significant differences were also apparent in the impact of simulated corrections on affected individuals across the three groups. Generally, individuals with scores below 600 were the most likely to experience a score increase of 10 points or more in

5 Estimated effects of data "corrections" on the credit history scores of individuals with "thin" files, by data problem corrected

Percent except as noted

Data problem corrected	Individuals affected	Distribution of individuals affected						Memo	
		Effect on credit history score					Total	Mean change in points	
		No change	Decrease		Increase			Individuals with decrease in score	Individuals with increase in score
			1–9 points	10 or more points	1–9 points	10 or more points			
Involving credit accounts									
Failure to close a									
Paid-as-agreed account	3.2	3.6	21.7	44.1	15.8	14.9	100.0	–17.0	11.3
Minor delinquent account	7	8.1	22.4	22.0	45.1	2.4	100.0	–16.0	3.7
Major derogatory account	2.4	88.7	5.4	0	5.9	0	100.0	–1.8	1.5
Failure of a subprime lender to report a paid-as-agreed account	n.c.	4.4	35.9	38.0	16.4	5.4	100.0	–12.3	6.8
Failure of largest student loan creditor to report	1.0	3.4	33.6	51.8	8.0	3.2	100.0	–20.8	6.8
Failure to report a									
Minor delinquency	n.c.	4.3	18.1	46.6	14.1	16.9	100.0	–24.9	9.8
Credit limit	9.1	18.2	1.4	.0	36.0	44.3	100.0	–1.2	13.2
Involving collection agency accounts									
Failure to eliminate duplicate collection agency accounts	1.9	7.4	8	0	82.4	9.5	100.0	–1.0	5.1
Reporting of									
Collection agency accounts under $100	15.2	48.0	3.0	6	35.8	12.6	100.0	–5.1	9.5
Medical collection accounts	20.9	10.6	1.7	9	52.0	34.9	100.0	–8.7	14.7
Potentially misassigned collection accounts	8.6	16.3	4.1	3.1	32.7	43.7	100.0	–10.7	26.6
Involving public records									
Reporting of duplicate public records	3	50.4	1.7	0	47.9	0	100.0	–1.0	1.0
Inclusion of lawsuits and dismissals	7	22.4	1.6	6	52.3	23.0	100.0	–6.3	13.4
Involving creditor inquiries									
Failure to consolidate									
Multiple inquiries for auto and mortgage loans	9	19.1	7.2	0	69.2	4.5	100.0	–2.1	3.4
Other multiple inquiries	9.5	4.9	3.4	0	87.0	4.7	100.0	–1.5	4.8

NOTE See note to table 3 A "thin" file has a record of a credit account but has fewer than four such accounts

n.c. Not calculable

response to corrections of data problems. Collection account problems provided an exception to this pattern: Affected individuals in the credit history score range above 660 were the most likely to experience large score increases. The reason for this result is that relatively high-score individuals with collection agency accounts generally have no other major derogatory information in their credit records and thus can show significant score increases when a derogatory is corrected.

For individuals with thin files, the incidence of data quality issues involving credit accounts was generally lower than that for all individuals, but the incidence of issues involving collection agency accounts was somewhat higher (compare table 5 with table 3). The result regarding credit accounts reflects the smaller number of accounts in the credit records of individuals with thin files and, consequently, the generally lower probability that such individuals will have data quality issues. The result concerning collection agency accounts is due to the higher probability that people with thin files will have such accounts. However, in simulations involving corrections to credit accounts, the effects on the credit history scores of individuals with thin files were either similar to or substantially larger than the effects on the scores of persons in the general population. For example, correcting a failure to close a paid-as-agreed account resulted in a decline in credit history score that was twice as large, on average, for individuals with thin files as it was for those in the population at large.

In general, older individuals and those living in higher-income and nonminority neighborhoods had the lowest incidence of data problems (table 6). The most-notable exception to this pattern was for failure to report a credit limit, which was less common among younger individuals and among individuals living in lower-income and predominantly minority neighborhoods. We do not report the changes in credit history scores of affected individuals for these decompositions of the sample because the comparisons are difficult to interpret without also accounting for differences in the incidence of thin files and in credit history scores across groups. In most cases, the effects of data quality problems were similar across groups after controlling for the differences in depth of

6 Share of individuals affected by data problems in credit records, distributed by selected demographic characteristics
Percent except as noted

Data problem	Age (years)			Income of census tract[1]			Share of minorities in census tract (percent)		
	Under 35	35–55	Over 55	Low or moderate	Middle	High	Less than 10	10–80	More than 80
Involving credit accounts									
Failure to close a									
Paid-as-agreed account	16.9	16 6	10.1	11.3	13 1	13 7	13 4	12 9	11 3
Minor delinquent account	2.0	1.4	.6	1 8	1 3	8	1 0	1 3	2 1
Major derogatory account	5.5	6.2	2.9	6.8	4.7	3.1	3 2	5 1	8 0
Failure of a subprime lender to report a paid-as-agreed account	n.c.	n.c.	n.c.	n c.	n.c	n.c	n.c.	n.c	n c.
Failure of largest student loan creditor to report	9.0	3 2	8	3.4	3.3	3 8	3.0	3 8	3 3
Failure to report a									
Minor delinquency	n.c.	n.c.	n c	n c.	n c	n c	n c	n.c	n c
Credit limit	31.5	40.3	37.4	27 7	31 7	40 0	33.7	33.5	28 0
Involving collection agency accounts									
Failure to eliminate duplicate collection agency accounts	1.9	1 2	.4	2 3	1 1	6	7	1.4	2 7
Reporting of									
Collection agency accounts under $100	15.1	11.5	5.0	17.0	11 1	6 4	8 7	11 7	16 9
Medical collection accounts	19.5	16.5	8 3	22.8	15 7	9.3	12 7	16.1	22 3
Potentially misassigned collection accounts	10.8	8.8	5.3	11.6	7.9	6 1	6 4	8.5	13 1
Involving public records									
Reporting of duplicate public records	.2	5	3	4	.4	3	4	.4	3
Inclusion of lawsuits and dismissals	.6	1.7	1 1	1.2	1.1	1 1	1.0	1 2	1 4
Involving creditor inquiries									
Failure to consolidate									
Multiple inquiries for auto and mortgage loans	5.4	5.3	2.1	3.3	3 7	3 9	3 8	3 7	3 3
Other multiple inquiries	19.6	17.7	10 0	15.9	14.1	14.6	12 8	15.3	17.5

NOTE See note to table 3

n c Not calculable

1 For definition of income of census tract, see note to chart 2

file and in credit history score. Exceptions generally involved instances in which either the youngest or the oldest age group was disproportionately affected. For example, individuals over age 55 were more likely to have increases of more than 10 points in their credit history scores when medical collections were dropped, and individuals under age 35 were more likely to have large increases in their scores when nonreporting of a credit limit was corrected.

SUMMARY AND CONCLUSIONS

Available evidence indicates that the information that credit-reporting agencies maintain on the credit-related experiences of consumers, and the credit history scoring models derived from these experiences, have substantially improved the overall quality of credit decisions while reducing the costs of such decisionmaking. The availability of these data has also greatly enhanced the process of screening prospective customers to facilitate the marketing of credit and insurance products, thereby reducing the costs of such marketing by limiting solicitations to customers who are most likely to qualify for the products. If not for the information that the agencies maintain, consumers on the whole would receive less credit at higher prices. Moreover, the credit-reporting system has become more comprehensive over the past decade or so with notable improvements, such as the adoption of common formats for reporting information and the enhanced reporting of information on credit limits and mortgages Recent congressional amendments to the FCRA have advanced prospects for future improvements as consumer access to credit records and credit history scores has improved.

Despite the benefits of the credit-reporting system, analysts have raised concerns about the accuracy, completeness, timeliness, and consistency of agency records and about the effects of these shortcomings on the cost and availability of credit. Clearly, for the benefits of the credit-reporting system to be realized, some reasonable degree of accuracy and completeness of credit reports is required. Moreover, the more accurate and complete the information assembled by credit-reporting agencies, the greater the potential for more efficiency in the credit-granting process and a reduction in costs to the advantage of both consumers

and creditors. Over the years, a number of studies have focused on the contents of credit records but have reached quite different conclusions about the degree to which such information is accurate and complete and about the implications of data limitations for credit availability and pricing.

This study extends earlier research and assesses the effects of data limitations and ambiguities in credit reports on the availability and pricing of credit by using a large, nationally representative sample of individuals with credit records from one of the three national credit-reporting agencies Specifically, we estimate the proportion of individuals who are likely to be materially affected by a number of different data problems, and we quantify the likely effect of each problem on the credit history scores of individuals. Because such effects can vary across different populations, we also separately evaluate the effects on individuals in different credit-risk categories and in different groups classified by age and by income and minority population of the neighborhoods where they live We emphasize that we use the terms "data problem" and "correction" in their broadest sense, as we do not necessarily observe actual errors and the appropriate correction is sometimes unclear.

This analysis of the effects of data problems on credit history scores indicates that the proportion of individuals affected by any single type of data problem appears to be small, with the exception of missing credit limits, which affected almost one-third of the individuals in the sample used for the simulations. Moreover, in most cases, the effect of each type of problem on the credit history scores of affected individuals was modest Two principal reasons explain this result First, most individuals have a large number of credit accounts, and thus problems in any given account have only a relatively small effect on the individuals' overall credit profiles. Second, credit modelers recognize many of these data problems when they construct and weight the factors used in credit history scoring models. Therefore, correcting the problems identified here is unlikely to substantially change the risk evaluation and access to credit for the typical individual

The analysis suggests, however, that the effects of data problems may be more substantial in some cases than in others. In particular, problems with collection accounts are much more likely to have significant effects on the credit history scores of affected individuals. Missing credit limits, simply because they occur so frequently, also represent an important data quality problem In general, individuals with relatively low credit history scores or those with thin files are more likely to experience significant effects when a data problem arises. The incidence of problems also varies across groups, with older individuals, those with higher credit history scores, and those living in higher-income and nonminority neighborhoods showing the lowest incidence

Our analysis shows that predicting the effects of "correcting" errors is not straightforward. Sometimes, effects were counterintuitive. For example, our analysis suggests that about one-fourth of the individuals affected by lenders' failure to report student loans would show increases in their credit history scores as a result This outcome occurs in part because, somewhat surprisingly, individuals with student loans have more accounts than does the average individual. The complexity of the results is underscored by the fact that some individuals show increases and some show decreases for every simulation. In large part, this result occurs because the corrections typically affect more than one factor, moving scores in different directions. This is particularly true for problems with credit accounts, which are likely to involve multiple factors

The research here highlights the importance of data reporters' supplying complete information in a timely manner How such reporting can be fully achieved in a voluntary system is unclear. The current system relies heavily on consumers to identify and dispute "incorrect" or missing items in their credit reports. One problem with this approach is that consumers have no incentive to challenge information that is favorable to them, even if it is in error. Our research indicates that even when data are incomplete or in error, they often have little or no bearing on an individual's credit history score or access to credit.

Currently, consumers have access only to general information about the types of factors that are weighed in credit evaluation, or in the case of credit denials, the chief reasons for the adverse action. On the one hand, lack of specific information may lead some consumers to believe that virtually any data quality issue is pertinent and should be disputed, causing the credit-reporting agencies and reporters to incur unnecessary costs to correct or update files. On the other hand, consumers may be unaware of the potential importance of specific data issues, such as missing credit limits, and may not take appropriate action. Some of these problems may be addressed by consumer education, whereas others are likely to continue for the foreseeable future.

Before these results are taken as definitive estimates of the effects of data quality issues on credit availability, several important caveats must be made. First, we have investigated only some potential sources of error. Most notably, we can say nothing

about the consequences of mistakenly including account records that do not belong to an individual in the individual's file Second, we have used only one credit-scoring model to simulate our results and have relied on our approximation to the model to quantify our results. Third, we have omitted manual reviews of credit records, which are part of many underwriting systems Such systems identify and address many data quality issues. Finally, we have used data from only one credit-reporting agency Creditors, particularly in the mortgage market, typically obtain data from all three national credit-reporting agencies for credit underwriting. Reconciling inconsistencies in data across the three agencies can lead to corrections of many of the data quality issues we have identified

Moreover, we have analyzed only the potential effects on credit history scores of addressing data quality issues We have said nothing about how such problems could be corrected, how much the corrections might cost, or what potential gains in efficiency might result from developing models based on more complete and accurate data. If the current level of accuracy and completeness is socially inefficient, reaching the optimal level may be difficult. Credit information has aspects of a classic public good. The parties that bear the costs of correcting errors or providing more timely and complete information may not receive much benefit from the improvement in accuracy. Further remedies, such as imposing additional legal liability penalties, may, in a system of voluntary reporting, lead to unintended consequences, including less information reporting and a less efficient and effective system. Policymakers need to weigh all of these considerations when they determine whether the current credit-reporting system should be changed and, if so, what changes should be made. □

Report on the Condition of the U.S. Banking Industry: First Quarter, 2004

Assets at reporting bank holding companies rose $325 billion (or 3.7 percent) in the first quarter, primarily because the fifty large bank holding companies were active acquirers of investment securities during the period.[1] Aggregate securities and money market assets increased $260 billion, with nearly all of that increase occurring at the fifty large bank holding companies Growth in investment securities at large institutions was associated with broader efforts, including derivatives transactions, intended to adjust interest rate sensitivity. The notional value of derivatives outstanding rose $6.3 trillion, or nearly 9 percent.

Loans grew only $75 billion, influenced by growth in holdings of mortgage loans but also by continuing softness in the commercial and industrial loan category. Unused commitments to lend grew more significantly ($100 billion, or 2 5 percent), with most of the growth occurring in credit cards and home equity lines of credit at large institutions.

Deposits grew $140 billion, a healthy 3 percent, but not sufficient to fund the quarter's asset growth Accordingly, nondeposit borrowings rose $125 billion, or nearly 5 percent. Robust asset growth also contributed to a small decline in the total risk-based and leverage capital ratios, which nonetheless remain well above regulatory minimum standards.

Net income of reporting bank holding companies reached nearly $30 billion for the quarter, an increase of $1 6 billion from the fourth quarter of 2003 Stronger net interest income (fueled by asset growth) and lower provisions for loan losses provided much of the improvement, along with $2 0 billion in gains associated with the sale of investment securities Nonperforming assets and net charge-offs continued their sustained decline—falling to roughly 1 percent of loans and 0 63 percent of average loans, respectively—allowing for the lower provisions. Non-interest income rose only modestly for the quarter as revenues generated by the origination and sale of new residential mortgage loans fell, influenced by earlier increases in mortgage interest rates and the corresponding slowdown in residential mortgage refinancings However, market-sensitive revenues and fees from servicing existing mortgages provided some support.

More than one-third of the quarterly increase in net income was provided by other bank holding companies, as shown in table 3. Profits at these other (smaller) bank holding companies improved $0.6 billion, or 14 percent, in the first quarter after two quarters of declining earnings. Much of this improvement was attributable to dramatically lower provisions for loan losses—down nearly 30 percent, which in turn reflected seasonal influences more than it reflected the credit cycle. Provisions for loan losses declined a similar proportion in the first quarter of 2003

1 The panel of fifty large bank holding companies has been updated on the basis of year-end 2003 data Data contained in this report do not reflect administrative changes in the organizational structure of HSBC and its U S affiliates made during the first quarter of 2004 Therefore, these data do not reflect the ownership of Household International (total assets of about $140 billion) by HSBC's U S affiliates These administrative changes will be fully incorporated into subsequent reports

Tables start on page 324

1. Financial characteristics of all reporting bank holding companies in the United States

Millions of dollars except as noted, not seasonally adjusted

Account or ratio[1, 2]	1999	2000	2001	2002	2003	2002		2003				2004
						Q3	Q4	Q1	Q2	Q3	Q4	Q1
Balance sheet												
Total assets	**6,223,385**	**6,716,552**	**7,448,060**	**7,941,074**	**8,819,602**	**7,787,276**	**7,941,074**	**8,176,833**	**8,672,207**	**8,693,939**	**8,819,602**	**9,144,284**
Loans	3,383,994	3,703,287	3,804,665	4,044,385	4,393,737	3,912,145	4,044,385	4,112,536	4,265,235	4,336,327	4,393,737	4,469,919
Securities and money market	2 082,339	2 190,998	2,558,749	2,853,808	3,285,958	2,854,868	2,853,808	3,007,215	3,214,738	3,172,498	3,285,958	3,544,192
Allowance for loan losses	-54,361	-58,811	-66,746	-71,958	-72,217	-70,307	-71,958	-71,713	-72,001	-71,413	-72,217	-71,474
Other	811,413	881,078	1,151,392	1,114,840	1,212,124	1,090,570	1,114,840	1,128,796	1,264,236	1,256,527	1,212,124	1,201,647
Total liabilities	**5,757,257**	**6,201,603**	**6,866,719**	**7,305,988**	**8,123,754**	**7,166,274**	**7,305,988**	**7,527,389**	**7,998,682**	**8,013,405**	**8,123,754**	**8,425,004**
Deposits	3,499,625	3,754,638	4,005,863	4,332,313	4,674,254	4,162,946	4,332,313	4,426,401	4,571,789	4,576,474	4,674,254	4,814,070
Borrowings	1,776,050	1,983,017	2,061,127	2,228,020	2,610,397	2,264,667	2,228,020	2,315,467	2,508,601	2,553,019	2,610,397	2,735,280
Other[3]	481,583	463,948	799,729	745,655	839,103	738,661	745,655	785,521	918,292	883,912	839,103	875,655
Total equity	**466,129**	**514,949**	**581,341**	**635,087**	**695,848**	**621,002**	**635,087**	**649,444**	**673,525**	**680,534**	**695,848**	**719,280**
Off-balance sheet												
Unused commitments to lend[4]	3,093,729	3,297,511	3,481 744	3,650,670	4,097,529	3,610,928	3,650,670	3,714,160	3,756,486	3,887,356	4,097,529	4,201,380
Securitizations outstanding[5]	n a	n a	276,717	295,001	298,348	287,846	295,001	284,429	285,286	290,328	298,348	293,705
Derivatives (notional value, billions)[6]	37,924	43,599	48,261	57,864	72,870	55 464	57,864	64,116	68,330	69,411	72,870	79,188
Income statement												
Net income[7]	76,961	72,557	65,488	84,678	106,603	21,535	18,732	24,777	26,348	27,265	28,321	29,905
Net interest income	187,552	195,769	221,626	242,923	254,199	60,163	61,700	62,279	63,168	63,899	65,038	66,367
Provisions for loan losses	20,071	26,874	39,522	42,928	31,535	11,150	11,545	8,574	8,428	7,110	7,425	6,006
Non-interest income	174,461	197,724	214,093	215,879	245,080	53,645	56,758	57,426	61,698	61,379	64,610	65,038
Non-interest expense	225,390	254,820	297,197	292,050	311,087	71,545	79,033	74,222	77,554	78,017	81,360	81,457
Security gains or losses	3,117	-614	4,297	4,503	5,764	1,772	1,644	1,854	2,675	583	664	1,973
Ratios (percent)												
Return on average equity	17 44	15 14	11 76	14 05	16 23	14 18	12 13	15 65	16 13	16 42	16 70	17 19
Return on average assets	1 30	1 12	90	1 10	1 26	1 12	94	1 22	1 25	1 26	1 29	1 33
Net interest margin[8]	3 71	3 56	3 58	3 72	3 49	3 68	3 63	3 58	3 50	3 43	3 46	3 42
Efficiency ratio[7]	60 91	62 61	65 75	62 40	61 52	62 72	65 65	62 01	62 59	62 20	62 39	62 17
Nonperforming assets to loans and related assets	85	1 09	1 45	1 46	1 16	1 65	1 46	1 43	1 34	1 24	1 16	1 04
Net charge-offs to average loans	54	65	89	1 02	81	1 08	1 02	84	80	75	83	63
Loans to deposits	96 70	98 63	94 98	93 35	94 00	93 98	93 35	92 91	93 29	94 75	94 00	92 85
Regulatory capital ratios												
Tier 1 risk-based	8 80	8 83	8 91	9 21	9 55	9 33	9 21	9 33	9 29	9 51	9 55	9 55
Total risk-based	11 73	11 80	11 91	12 29	12 58	12 37	12 29	12 42	12 30	12 52	12 58	12 52
Leverage	7 00	6 80	6 66	6 70	6 84	6 79	6 70	6 72	6 75	6 74	6 84	6 83
Number of reporting bank holding companies	1,647	1,727	1,842	1,979	2,134	1,946	1,979	2,036	2,064	2,120	2,134	2,191

Footnotes appear on p 327

2 Financial characteristics of fifty large bank holding companies in the United States

Millions of dollars except as noted, not seasonally adjusted

Account or ratio[2 9]	1999	2000	2001	2002	2003	2002		2003				2004
						Q3	Q4	Q1	Q2	Q3	Q4	Q1
Balance sheet												
Total assets	**5,044,007**	**5,415,534**	**5,771,881**	**6,113,304**	**6,754,540**	**6,003,515**	**6,113,304**	**6,283,387**	**6,670,009**	**6,682,600**	**6,754,540**	**7,045,844**
Loans	2,638,594	2,869,704	2,882,304	3,052,011	3,289,320	2,938,492	3,052,011	3,099,399	3,204,451	3,258,498	3,289,320	3,347,029
Securities and money market	1,744,617	1,827,922	2,025,282	2,249,617	2,589,207	2,267,847	2,249,617	2,362,594	2,527,960	2,493,425	2,589,207	2,832,561
Allowance for loan losses	–43,972	–47,022	–53,709	–57,499	–56,862	–56,209	–57,499	–56,839	–56,748	–55,951	–56,862	–55,742
Other	704,768	764,930	918,005	869,175	932,875	853,385	869,175	878,234	994,346	986,628	932,875	921,996
Total liabilities	**4,677,788**	**5,012,301**	**5,332,921**	**5,638,416**	**6,238,516**	**5,539,009**	**5,638,416**	**5,799,916**	**6,170,671**	**6,176,065**	**6,238,516**	**6,511,119**
Deposits	2,627,896	2,788,209	2,959,554	3,186,709	3,427,557	3,044,933	3,186,709	3,244,626	3,359,696	3,353,369	3,427,557	3,543,238
Borrowings	1,596,140	1,788,955	1,843,867	2,001,008	2,314,793	2,040,619	2,001,008	2,075,842	2,225,926	2,271,690	2,314,793	2,451,353
Other[3]	453,752	435,138	529,501	450,699	496,166	453,456	450,699	479,448	585,050	551,006	496,166	516,528
Total equity	**366,220**	**403,233**	**438,960**	**474,889**	**516,024**	**464,506**	**474,889**	**483,472**	**499,338**	**506,535**	**516,024**	**534,726**
Off balance-sheet												
Unused commitments to lend[4]	2,866,318	3,061,455	3,223,389	3,368,731	3,781,780	3,330,997	3,368,731	3,420,124	3,451,764	3,574,976	3,781,780	3,878,766
Securitizations outstanding[5]	n a	n a	271,522	289,125	292,178	282,997	289,125	278,455	278,920	283,990	292,178	289,460
Derivatives (notional value, billions)[6]	37,876	43,521	48,130	57,731	72,663	55,315	57,731	63,959	68,144	69,220	72,663	78,941
Income statement												
Net income[7]	63,918	59,154	50,885	66,424	85,402	16,779	14,247	19,688	20,863	21,969	22,990	24,124
Net interest income	145,090	149,712	161,777	178,377	186,654	43,504	45,830	45,721	46,238	47,170	47,710	48,895
Provisions for loan losses	17,050	22,980	34,231	36,912	26,710	9,649	9,822	7,430	7,140	5,874	6,266	5,175
Non-interest income	155,301	177,094	168,028	165,358	188,222	41,425	42,421	44,170	47,292	47,221	49,571	50,649
Non-interest expense	186,077	211,635	217,391	208,612	221,559	51,005	56,518	52,831	55,210	55,983	57,601	58,579
Security gains or losses	2,224	–611	4,229	4,863	5,122	1,951	1,753	1,727	2,308	469	631	1,585
Ratios (percent)												
Return on average equity	18 61	15 81	12 09	14 64	17 49	14 71	12 33	16 68	17 24	17 78	18 22	18 61
Return on average assets	1 33	1 13	90	1 12	1 31	1 13	93	1 26	1 29	1 31	1 37	1 39
Net interest margin[8]	3 58	3 42	3 35	3 53	3 33	3 44	3 48	3 41	3 32	3 28	3 31	3 26
Efficiency ratio[7]	60 46	62 51	63 03	59 49	58 35	60 21	62 85	59 07	59 46	59 24	58 80	59 23
Nonperforming assets to loans and related assets	90	1 19	1 59	1 59	1 24	1 84	1 59	1 52	1 42	1 31	1 24	1 08
Net charge-offs to average loans	61	74	1 02	1 18	94	1 28	1 18	1 01	94	86	94	76
Loans to deposits	100 41	102 92	97 39	95 77	95 97	96 50	95 77	95 52	95 38	97 17	95 97	94 46
Regulatory capital ratios												
Tier 1 risk-based	8 09	8 17	8 19	8 47	8 74	8 63	8 47	8 57	8 50	8 76	8 74	8 74
Total risk-based	11 32	11 45	11 56	11 94	12 14	12 09	11 94	12 05	11 89	12 14	12 14	12 06
Leverage	6 61	6 40	6 20	6 20	6 29	6 32	6 20	6 21	6 23	6 23	6 29	6 27

Footnotes appear on p 327

3 Financial characteristics of all other reporting bank holding companies in the United States

Millions of dollars except as noted, not seasonally adjusted

Account[1, 10]	1999	2000	2001	2002	2003	2002		2003				2004
						Q3	Q4	Q1	Q2	Q3	Q4	Q1
Balance sheet												
Total assets	**1,150,598**	**1,267,495**	**1,374,372**	**1,510,055**	**1,654,954**	**1,474,065**	**1,510,055**	**1,560,906**	**1,610,240**	**1,619,654**	**1,654,954**	**1,678,459**
Loans	*734,118*	*820,595*	874,164	*945,177*	*1,033,891*	*925,905*	*945,177*	964,523	993,042	*1,008,162*	*1,033,891*	*1,052,311*
Securities and money market	321,785	344,394	382,380	435,754	480,900	424,233	435,754	466,110	480,658	474,675	480,900	489,879
Allowance for loan losses	−10,212	−11,580	−12,697	−14,047	−14,964	−13,759	−14,047	−14,458	−14,746	−15,003	−14,964	−15,347
Other	*104,907*	*114,086*	*130,525*	*143,171*	*155,128*	*137,686*	*143,171*	*144,731*	*151,287*	*151,820*	*155,128*	*151,616*
Total liabilities	**1,052,605**	**1,157,787**	**1,252,341**	**1,372,425**	**1,504,937**	**1,338,734**	**1,372,425**	**1,418,270**	**1,463,155**	**1,472,908**	**1,504,937**	**1,525,064**
Deposits	871,728	966,346	1,040,061	1 136,674	1,234,440	1,111,248	1,136,674	1,172,534	1,201,071	1,211,527	1,234,440	1,256,851
Borrowings	158,337	164,375	183,790	201,571	232,986	193,152	201,571	208,955	223,476	224,492	232,986	224,877
Other[3]	22,540	27,066	28,491	34,179	37,510	34,333	34,179	36,781	38,607	36,889	37,510	43,336
Total equity	**97,994**	**109,708**	**122,031**	**137,630**	**150,017**	**135,332**	**137,630**	**142,636**	**147,085**	**146,746**	**150,017**	**153,395**
Off-balance sheet												
Unused commitments to lend[4]	216,083	227,707	248,671	270,590	303,309	268,346	270,590	282,775	293,012	300,237	303,309	309,232
Securitizations outstanding[5]	n a	n a	4,871	5 137	5,026	4,398	5,137	5,172	5,368	5,260	5,026	3,121
Derivatives (notional value, billions)[6]	35	65	102	101	110	120	101	113	119	114	110	137
Income statement												
Net income[7]	12,895	13,383	14,546	17 586	18,929	4,576	4,297	4,714	4,928	4,825	4,462	5,088
Net interest income	42,379	46,063	48,534	53,713	55,847	13,796	13,531	13,775	13,966	13,873	14,233	14,456
Provisions for loan losses	2,927	3,751	4,856	5 386	4,609	1,424	1,519	1,077	1,199	1,116	1,218	866
Non interest income	17,359	18,696	23,897	26,230	29,671	6,633	7,031	7,084	7,791	7,447	7,349	7,221
Non interest expense	37,797	41,444	46,689	49,510	54,195	12,391	13,037	13,010	13,651	13,389	14,145	13,772
Security gains or losses	825	−9	777	722	1,074	261	188	302	432	140	201	328
Ratios (percent)												
Return on average equity	13 26	12 99	12 32	13 60	13 15	13 86	12 72	13 46	13 69	13 42	12 08	13 59
Return on average assets	1 16	1 11	1 11	1 24	1 20	1 27	1 16	1 24	1 25	1 21	1 09	1 23
Net interest margin[8]	4 27	4 24	4 12	4 21	3 94	4 31	4 08	4 03	3 97	3 87	3 89	3 92
Efficiency ratio[7]	62 47	62 35	63 53	60 91	62 59	60 31	63 13	61 72	63 42	62 56	65 45	62 84
Nonperforming assets to loans and related assets	69	76	97	1 02	97	1 03	1 02	1 13	1 08	1 02	97	96
Net charge-offs to average loans	30	32	44	47	40	46	53	32	39	36	52	24
Loans to deposits	84 21	84 92	84 05	83 15	83 75	83 32	83 15	82 26	82 68	83 21	83 75	83 73
Regulatory capital ratios												
Tier 1 risk-based	12 24	11 90	12 16	12 39	12 53	12 50	12 39	12 55	12 49	12 51	12 53	12 51
Total risk-based	13 71	13 39	13 79	14 06	14 27	14 15	14 06	14 24	14 21	14 25	14 27	14 24
Leverage	8 65	8 57	8 74	8 86	9 00	8 97	8 86	8 95	8 91	8 92	9 00	9 06
Number of other reporting bank holding companies	1,570	1,663	1,788	1,925	2,080	1,892	1,925	1,982	2,010	2,066	2,080	2,137

Footnotes appear on p 327

4 Nonfinancial characteristics of all reporting bank holding companies in the United States

Millions of dollars except as noted, not seasonally adjusted

Account	1999	2000	2001	2002	2003	2002		2003				2004
						Q3	Q4	Q1	Q2	Q3	Q4	Q1
Bank holding companies that qualify as financial holding companies [11, 12]												
Domestic												
Number	n a	299	388	434	451	415	434	437	440	448	451	462
Total assets	n a	4,494,270	5,436,785	5,916,859	6,605,638	5,706,966	5,916,859	6,061,696	6,433,736	6,447,130	6,605,638	6,839,802
Foreign-owned [13]												
Number	n a	9	10	11	12	11	11	11	11	11	12	13
Total assets	n a	502,506	621,442	616,254	710,441	689,804	616,254	648,017	732,695	729,244	710,441	856,185
Total U S commercial bank assets [14]	**5,673,702**	**6,129,534**	**6,415,909**	**6,897,447**	**7,397,878**	**6,762,780**	**6,897,447**	**7,031,274**	**7,325,357**	**7,293,984**	**7,397,878**	**7,614,338**
By ownership												
Reporting bank holding companies	5,226,027	5,657,210	5,942,575	6,429,738	6,941,083	6,296,385	6,429,738	6,577,712	6,863,188	6,842,825	6,941,083	7,165,394
Other bank holding companies	226,916	229,274	230,464	227,017	219,223	226,602	227,017	222,670	222,997	217,036	219,223	213,356
Independent banks	220,759	243,050	242,870	240,692	237,572	239,793	240,692	230,893	239,172	234,122	237,572	235,589
Assets associated with nonbanking activities [12, 15]												
Insurance	n a	n a	426,462	350,633	411,926	338,384	350,633	359,968	383,999	398,378	411,926	428,085
Securities broker–dealers	n a	n a	n a	630,851	656,775	703,738	630,851	709,839	659,701	686,049	656,775	713,794
Thrift institutions	117 699	102,218	91,170	107,422	133,056	56,063	107,422	126,375	124,640	143,578	133,056	139,713
Foreign nonbank institutions	78,712	132,629	138,977	145,344	170,600	144,814	145,344	154,812	160,515	162,789	170,600	195,472
Other nonbank institutions	879,793	1,234,714	1,674,267	561,712	686,423	493,777	561,712	524,709	737,434	736,515	686,423	698,281
Number of bank holding companies engaged in nonbanking activities [12, 15]												
Insurance	n a	n a	143	86	101	91	86	90	91	100	101	99
Securities broker–dealers	n a	n a	n a	47	50	47	47	48	50	46	50	49
Thrift institutions	57	50	38	32	27	37	32	31	31	29	27	29
Foreign nonbank institutions	25	25	32	37	41	38	37	38	40	39	41	41
Other nonbank institutions	559	633	743	880	1,043	835	880	913	945	992	1,043	1,031
Foreign-owned bank holding companies [13]												
Number	18	21	23	26	28	24	26	26	27	28	28	28
Total assets	535,024	636,669	764,411	762,901	934,781	827,867	762 901	799,540	946,847	947,932	934,781	1,007,694
Employees of reporting bank holding companies (full-time equivalent)	1,775,418	1,859,930	1,985,981	1,992,559	2,034,358	1,979,260	1,992,559	2,000,168	2,019,953	2,031,029	2,034,358	2,099,709
Assets of fifty large bank holding companies [9, 17]												
Fixed panel (from table 2)	5,044,007	5,415,534	5,771,881	6,113,304	6,754,540	6,003,515	6,113,304	6,283,387	6,670,009	6,682,600	6,754,540	7,045,844
Fifty large as of reporting date	4 809,785	5,319,129	5 732,621	6,032,000	6,666,488	5,951,115	6,032,000	6,203,000	6,587,000	6,602,255	6,666,488	7,045,844
Percent of all reporting bank holding companies	77 30	79 20	77 00	76 00	75 60	76 40	76 00	75 90	76 00	75 90	75 60	77 10

NOTE All data are as of the most recent period shown The historical figures may not match those in earlier versions of this table because of mergers, significant acquisitions or divestitures, or revisions or restatements to bank holding company financial reports Data for the most recent period may not include all late-filing institutions

1 Covers top-tier bank holding companies except (1) those with consolidated assets of less than $150 million and with only one subsidiary bank and (2) multibank holding companies with consolidated assets of less than $150 million, with no debt outstanding to the general public and not engaged in certain nonbanking activities

2 Data for all reporting bank holding companies and the fifty large bank holding companies reflect merger adjustments to the fifty large bank holding companies Merger adjustments account for mergers, acquisitions, other business combinations and large divestitures that occurred during the time period covered in the tables so that the historical information on each of the fifty underlying institutions depicts, to the greatest extent possible, the institutions as they exist in the most recent period In general, adjustments for mergers among bank holding companies reflect the combination of historical data from predecessor bank holding companies

The data for the fifty large bank holding companies have also been adjusted as necessary to match the historical figures in each company's most recently available financial statement

In general, the data are not adjusted for changes in generally accepted accounting principles

3 Includes minority interests in consolidated subsidiaries

4 Includes credit card lines of credit as well as commercial lines of credit

5 Includes loans sold to securitization vehicles in which bank holding companies retain some interest, whether through recourse or seller-provided credit enhancements or by servicing the underlying assets Securitization data were first collected on the FR Y-9C report for June 2001

6 The notional value of a derivative is the reference amount of an asset on which an interest rate or price differential is calculated The total notional value of a bank holding company's derivatives holdings is the sum of the notional values of each derivative contract regardless of whether the bank holding company is a payor or recipient of payments under the contract The actual cash flows and fair market values associated with these derivative contracts are generally only a small fraction of the contract's notional value

7 Income statement subtotals for all reporting bank holding companies and the fifty large bank holding companies exclude extraordinary items, the cumulative effects of changes in accounting principles, and discontinued operations at the fifty large institutions and therefore will not sum to Net income The efficiency ratio is calculated excluding nonrecurring income and expenses

8 Calculated on a fully-taxable equivalent basis

9 In general, the fifty large bank holding companies are the fifty largest bank holding companies as measured by total consolidated assets for the latest period shown Excludes a few large bank holding companies whose commercial banking operations account for only a small portion of assets and earnings

10 Excludes predecessor bank holding companies that were subsequently merged into other bank holding companies in the panel of fifty large bank holding companies Also excludes those bank holding companies excluded from the panel of fifty large bank holding companies because commercial banking operations represent only a small part of their consolidated operations

11 Exclude qualifying institutions that are not reporting bank holding companies

12 No data related to financial holding companies and only some data on nonbanking activities were collected on the FR Y-9C report before implementation of the Gramm–Leach-Bliley Act in 2000

13 A bank holding company is considered "foreign-owned" if it is majority-owned by a foreign entity Data for foreign-owned companies do not include data for branches and agencies of foreign banks operating in the United States

14 Total assets of insured commercial banks in the United States as reported in the commercial bank Call Report (FFIEC 031 or 041, Reports of Condition and Income) Excludes data for a small number of commercial banks owned by other commercial banks that file separate call reports yet are also covered by the reports filed by their parent banks Also excludes data for mutual savings banks

15 Data for thrift, foreign nonbank, and other nonbank institutions are total assets of each type of subsidiary as reported in the FR Y-9LP report Data cover those subsidiaries in which the top-tier bank holding company directly or indirectly owns or controls more than 50 percent of the outstanding voting stock and that has been consolidated using generally accepted accounting principles Data for securities broker–dealers are net assets (that is, total assets, excluding intercompany transactions) of broker–dealer subsidiaries engaged *in activities* pursuant to the Gramm-Leach-Bliley Act, as reported on schedule HC-M of the FR Y-9C report Data for insurance activities are all insurance-related assets held by the bank holding company as reported on schedule HC-I of the FR Y-9C report

Beginning in 2002 Q1, insurance totals exclude intercompany transactions and subsidiaries engaged in credit-related insurance or those engaged principally in insurance agency activities *Beginning in* 2002 Q2, *insurance totals include only newly authorized insurance* activities under the Gramm–Leach–Bliley Act

16 Aggregate assets of thrift subsidiaries were affected significantly by the conversion of Charter One's thrift subsidiary (with assets of $37 billion) to a commercial bank in the second quarter of 2002 and the acquisition by Citigroup of Golden State Bancorp (a thrift institution with assets of $55 billion) in the fourth quarter of 2002

17 *Changes over time in the total assets of the time-varying panel of fifty large bank holding* companies are attributable to (1) changes in the companies that make up the panel and (2) to a small extent, restatements of financial reports between periods

n a Not available

SOURCE Federal Reserve Reports FRY-9C and FR Y-9LP, Federal Reserve National Information Center, and published financial reports

Staff Studies

The staff members of the Board of Governors of the Federal Reserve System and of the Federal Reserve Banks undertake studies that cover a wide range of economic and financial subjects From time to time, the studies that are of general interest are published in the Staff Studies series and summarized in the Federal Reserve Bulletin. *The analyses and conclusions set forth are those of the authors and do not necessarily indicate concurrence by the Board of Governors, by the Federal Reserve Banks, or by members of their staffs.*

Single copies of the full text of each study are available without charge. The titles available are shown under "Staff Studies" in the list of Federal Reserve Board publications at the back of each Bulletin.

STAFF STUDY 176: SUMMARY

BANK MERGER ACTIVITY IN THE UNITED STATES, 1994–2003

Steven J. Pilloff

Mergers and acquisitions have significantly changed the U.S. banking industry over the past quarter century This study examines patterns in the 3,517 mergers consummated among commercial banks and thrift institutions (savings banks, savings and loan associations, and industrial banks) during the ten years from 1994 to 2003 The data used in this study include the vast majority of consolidation activity that took place during the period and are more detailed and comprehensive than any data available for the years preceding 1994.

About $3.1 trillion in assets, $2.1 trillion in deposits, and 47,300 offices were acquired during the ten-year period The annual number of mergers was fairly steady between 1994 and 1998 and then declined to a much lower level by 2003 Roughly three-fourths of all deals involved two commercial banking organizations. The remaining mergers involved a thrift institution as the acquirer, the target, or both. The target in the median merger during the period had $102 million in assets, $86 million in deposits, and 3 offices Mean (average) values are substantially higher because of a relatively small number of extremely large deals. $874 million in assets, $601 million in deposits, and 13 offices

Whether calculated as a mean or median, roughly 5 percent of the industry's assets, deposits, and offices were acquired in mergers in the typical year in the period. The peak was in 1998. The number of deals completed then (493) was not far larger than the number in earlier years, but the aggregate amounts of assets and deposits purchased in 1998 were roughly twice the second-highest annual levels of the period (recorded in 1996)

Most deals involved the acquisition of a small organization with operations in a fairly limited geographic area. In the aggregate these small mergers tended to account for a relatively small share of the assets, deposits, and offices that were purchased. In contrast, the few acquisitions of very large banks accounted for a large share of the assets, deposits, and offices acquired, and they were responsible for many of the changes to the banking industry caused by consolidation

Urban markets had disproportionately more mergers than rural markets, and mergers with targets in urban areas accounted for an even larger share of acquired deposits and offices. Urban markets were also more likely than rural markets to be the location of a merger in which the acquirer already had an office in the market.

Acquisitions took place in every state, but the level of activity varied greatly by state. The large majority of mergers involved a target that operated in a single state and an acquirer with at least one office in that state □

Announcements

STATEMENT BY CHAIRMAN ALAN GREENSPAN ON NOMINATION FOR FIFTH TERM

"I am honored to be nominated by President Bush and, if confirmed by the Senate, to continue my service as Chairman of the Board of Governors of the Federal Reserve System."

CHAIRMAN GREENSPAN TAKES OATH OF OFFICE

Chairman Alan Greenspan on June 19, 2004, took the oath of office as Chairman of the Board of Governors of the Federal Reserve System for a fifth four-year term commencing on June 20, 2004 The oath was administered by Vice President Dick Cheney at the Colorado home of former President Gerald Ford. Witnesses included President and Mrs. Ford and Chairman Greenspan's wife, Andrea Mitchell.

President Bush nominated Dr. Greenspan on May 18, 2004, and he was confirmed by the Senate on June 17, 2004. He originally took office on August 11, 1987

FEDERAL OPEN MARKET COMMITTEE STATEMENTS

The Federal Open Market Committee decided on May 4, 2004, to keep its target for the federal funds rate at 1 percent

The Committee continues to believe that an accommodative stance of monetary policy, coupled with robust underlying growth in productivity, is providing important ongoing support to economic activity The evidence accumulated over the intermeeting period indicates that output is continuing to expand at a solid rate and hiring appears to have picked up. Although incoming inflation data have moved somewhat higher, long-term inflation expectations appear to have remained well contained.

The Committee perceives the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. Similarly, the risks to the goal of price stability have moved into balance. At this juncture, with inflation low and resource use slack, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured.

Voting for the FOMC monetary policy action were: Alan Greenspan, Chairman; Timothy F. Geithner, Vice Chairman, Ben S. Bernanke; Susan S. Bies, Roger W. Ferguson, Jr.; Edward M Gramlich, Thomas M. Hoenig; Donald L Kohn; Cathy E. Minehan; Mark W. Olson; Sandra Pianalto; and William Poole.

The Federal Open Market Committee decided on June 30, 2004, to raise its target for the federal funds rate 25 basis points to 1¼ percent

The Committee believes that, even after this action, the stance of monetary policy remains accommodative and, coupled with robust underlying growth in productivity, is providing ongoing support to economic activity. The evidence accumulated over the intermeeting period indicates that output is continuing to expand at a solid pace and labor market conditions have improved. Although incoming inflation data are somewhat elevated, a portion of the increase in recent months appears to have been due to transitory factors.

The Committee perceives the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters are roughly equal. With underlying inflation still expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

Voting for the FOMC monetary policy action were: Alan Greenspan, Chairman; Timothy F. Geithner, Vice Chairman, Ben S. Bernanke; Susan S. Bies, Roger W Ferguson, Jr.; Edward M Gramlich, Thomas M. Hoenig, Donald L. Kohn; Cathy E Minehan; Mark W. Olson; Sandra Pianalto; and William Poole.

In a related action, the Board of Governors approved a 25 basis point increase in the discount rate to 2¼ percent. In taking this action, the Board approved the requests submitted by the Boards of Directors of the Federal Reserve Banks of Boston,

New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St Louis, Minneapolis, Kansas City, Dallas, and San Francisco

PROPOSED AMENDMENT TO REGULATION J

The Federal Reserve Board on June 4, 2004, proposed amending Regulation J, (Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfers through Fedwire), which governs Reserve Banks' collection of checks and other cash items, to cover the entire range of check-processing services that the Reserve Banks plan to offer once the Check Clearing for the 21st Century Act takes effect on October 28, 2004

The Check 21 Act permits banks to use substitute checks in place of original checks in the check collection or return process The act does not require any bank to accept checks electronically, but facilitates the use of electronic transmission between banks that agree to use that technology In light of the act's provisions, the Reserve Banks plan to offer a wider range of electronic check-processing services The proposed amendments would bring electronic items within the scope of Regulation J and would establish new warranties and an indemnity that would apply to electronic items for which there is no other warranty and indemnity protection

AMENDMENTS TO REGULATION V

The Federal Reserve Board on June 8, 2004, issued amendments to Regulation V (Fair Credit Reporting), which implements the Fair Credit Reporting Act (FCRA), that would add model notices for financial institutions to use if they furnish negative information to consumer reporting agencies The amendments also provide guidance to financial institutions regarding the use of the model notices. The Board is publishing the model notices pursuant to the Fair and Accurate Credit Transactions Act (FACT Act) amendments to the FCRA

The FACT Act provides that if any financial institution (1) extends credit and regularly and in the ordinary course of business furnishes information to a nationwide consumer reporting agency; and (2) furnishes negative information to such an agency regarding credit extended to a customer, the institution must provide a clear and conspicuous notice about furnishing negative information, in writing, to the customer. *Negative information* means information concerning a customer's delinquencies, late payments, insolvency, or any form of default

The FACT Act defines the term *financial institution* to have the same meaning as in the privacy provisions of the Gramm–Leach–Bliley Act The term *financial institution* includes not only institutions regulated by the Board and other federal banking agencies, but also includes other financial entities, such as merchant creditors that extend credit and report negative information The Board's model notices can be used by all financial institutions, as defined by the act.

The amendments became effective July 16, 2004.

AMENDMENTS TO REGULATION CC, APPENDIX A

Restructuring of Check-Processing Operations in the Eleventh, Seventh, Eighth, Fourth, and Fifth Districts

The Federal Reserve Board on May 4, 2004, announced amendments to Appendix A of Regulation CC (Availability of Funds and Collection of Checks), effective July 10, 2004, that reflect the restructuring of the Federal Reserve's check-processing operations in the Eleventh District

On May 17, 2004, the Federal Reserve Board announced amendments to Appendix A of Regulation CC, that reflect the restructuring of the Federal Reserve's check-processing operations in the Seventh and Eighth Districts.

On June 22, 2004, the Federal Reserve Board announced amendments to Appendix A of Regulation CC, that reflect the restructuring of the Federal Reserve's check-processing operations in the Fourth, Fifth, and Eighth Districts

These amendments are part of a series of amendments to appendix A that will take place through the end of 2004, associated with the previously announced restructuring of the Reserve Banks' check-processing operations

Appendix A provides a routing number guide that helps depository institutions determine the maximum permissible hold periods for most deposited checks As of July 10, 2004, the San Antonio office of the Federal Reserve Bank of Dallas no longer processes checks, and banks served by that office for check-processing purposes were reassigned to the Reserve Bank's head office in Dallas To reflect this operational change, the final rule deletes the reference in appendix A to the San Antonio office and reassigns the routing numbers listed thereunder to the Reserve Bank's head office.

As of July 24, 2004, the Little Rock office of the Federal Reserve Bank of St. Louis no longer processes checks, and banks served by that office for check-processing purposes have been reassigned to the Reserve Bank's Memphis office.

As of August 7, 2004, the Milwaukee office of the Federal Reserve Bank of Chicago no longer processes checks, and banks served by that office have been reassigned to the Reserve Bank's head office. To reflect these operational changes, the final rule (1) deletes the reference in appendix A to the St Louis Reserve Bank's Little Rock office and reassigns the routing numbers listed thereunder to the Reserve Bank's Memphis office, effective July 24, 2004, and (2) deletes the reference in appendix A to the Chicago Reserve Bank's Milwaukee office and reassigns the routing numbers listed thereunder to the Reserve Bank's head office, effective August 7, 2004.

As of August 28, 2004, the Columbia office of the Federal Reserve Bank of Richmond no longer processes checks, and banks served by that office have been reassigned to that Reserve Bank's Charlotte office

Also as of August 28, 2004, the Louisville office of the Federal Reserve Bank of St. Louis no longer processes checks, and banks served by that office for check-processing purposes have been reassigned to the Cincinnati office of the Federal Reserve Bank of Cleveland

To reflect these operational changes, the final rule (1) deletes the reference in appendix A to the Richmond Reserve Bank's Columbia office and reassigns the routing numbers listed thereunder to that Reserve Bank's Charlotte office, and (2) deletes the reference in appendix A to the St Louis Reserve Bank's Louisville office and reassigns the routing numbers listed thereunder to the Cleveland Reserve Bank's Cincinnati office. To coincide with the effective date of the underlying check-processing changes, the amendments were effective August 28, 2004.

As a result of these changes, some checks deposited in the affected regions that were nonlocal checks have become local checks that are subject to shorter permissible hold periods

FINAL AMENDMENTS TO REGULATION CC AND ITS COMMENTARY TO IMPLEMENT CHECK 21 ACT

The Federal Reserve Board on July 26, 2004, released final amendments to Regulation CC and its commentary to implement the Check Clearing for the 21st Century Act (Check 21 Act), which was enacted on October 28, 2003, and becomes effective on October 28, 2004

To facilitate check truncation and electronic check exchange, the Check 21 Act authorizes a new negotiable instrument called a *substitute check.* A substitute check is a paper reproduction of the original check that contains an image of the front and back of the original check and can be processed just like the original check. The Check 21 Act provides that a properly prepared substitute check is the legal equivalent of the original check for all purposes. The Check 21 Act does not require any bank to create substitute checks or to accept checks electronically. The Check 21 Act includes new warranties, an indemnity, and expedited re-credit procedures that protect substitute check recipients

The Board's amendments. (1) set forth the requirements of the Check 21 Act that apply to banks, (2) provide a model disclosure and model notices relating to substitute checks; and (3) set forth bank endorsement and identification requirements for substitute checks The amendments also clarify some existing provisions of the rule and commentary

PROPOSED AMENDMENTS PUBLISHED TO REGULATION DD

The Federal Reserve Board on May 28, 2004, published proposed amendments to Regulation DD (Truth in Savings), which implements the Truth in Savings Act, and the regulation's official staff commentary to address concerns about the uniformity and adequacy of information provided to consumers when they overdraw their accounts. The proposed amendments, in part, address a specific service offered by depository institutions, commonly referred to as *bounced-check protection* or *courtesy overdraft protection.*

Depository institutions sometimes offer courtesy overdraft protection to deposit account customers as an alternative to a traditional overdraft line of credit To address concerns about the marketing of this service, a proposed revision to the regulation would expand the prohibition against misleading advertisements to cover communications with current customers about existing accounts. The staff commentary would provide examples Other proposed revisions to Regulation DD would require additional fee and other disclosures about courtesy overdraft services, including in advertisements

The Board is also proposing amendments of general applicability that would require institutions to provide more uniform disclosures about overdraft and returned-item fees.

In addition, the member agencies of the Federal Financial Institutions Examination Council published proposed guidance to assist insured depository institutions in the responsible disclosure and administration of overdraft protection services

WITHDRAWAL OF PROPOSED REVISIONS TO REGULATIONS B, E, M, Z, AND DD

The Federal Reserve Board on June 22, 2004, withdrew proposed revisions to Regulation B (Equal Credit Opportunity), Regulation E (Electronic Fund Transfers), Regulation M (Consumer Leasing), Regulation Z (Truth in Lending), and Regulation DD (Truth in Savings) The proposed revisions, published in December 2003, sought to define more specifically the standard for providing *clear and conspicuous* disclosures and to provide a more-uniform standard among the Board's regulations

The revisions were intended to help ensure that consumers receive noticeable and understandable information that is required by law in connection with obtaining consumer financial products and services In response to concerns raised by commenters, the Board has determined that this goal should be achieved by developing proposals that focus on improving the effectiveness of individual disclosures rather than the adoption of general definitions and standards applicable across the five regulations. This effort will be undertaken in connection with the Board's periodic review of its regulations, an advance notice of proposed rulemaking is expected to be issued later this year under Regulation Z, focused on disclosures for open-end credit accounts

Although the December 2003 proposals are withdrawn, they reflect principles that institutions may find useful in creating disclosures that are clear and conspicuous. These approaches will also help inform the Board's review of individual disclosures.

INTENT TO WITHDRAW PROPOSED AMENDMENTS TO COMMUNITY REINVESTMENT ACT REGULATIONS

The Federal Reserve Board on July 16, 2004, announced its intention to withdraw proposed amendments to its Community Reinvestment Act (CRA) regulations Regulation BB, Community Reinvestment)

In February 2004, the Board, along with the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation, proposed revisions to the agencies' CRA regulations The key aspects of the proposal were (1) to raise the small-bank asset threshold from $250 million to $500 million thereby allowing more banks to benefit from streamlined CRA evaluations; and (2) to allow examiners to reduce a depository institution's CRA rating if the institution engaged in a pattern or practice of abusive asset-based lending.

Although community banks strongly favor raising the threshold, it is uncertain that the cost savings to the average community bank of being "small" rather than "large" under the proposal would be significant On the other side, the proposal's cost in the form of a potential reduction in community development capital in a significant number of rural communities is also uncertain, but potentially large in at least some communities. On balance, the Board does not believe that the cost savings of the proposal clearly justify the potential adverse effects on certain rural communities.

The commenters were united in their opposition to the proposal to define a single abusive lending practice in the CRA regulations (abusive asset-based lending) to the exclusion of other abusive practices

For these reasons, the Board is withdrawing the entire proposal.

BOARD OF GOVERNORS REQUESTS COMMENT

Proposed Revision to Policy Statement on Payments System Risk

The Federal Reserve Board on April 21, 2004, requested comment on proposed revisions to Part II of its Policy Statement on Payments System Risk (PSR Policy), which addresses risk management in payments and securities settlement systems

The proposed revisions update the policy in light of current industry and supervisory risk management approaches and new international risk management standards for payments and securities settlement systems In addition, they provide further clarification regarding the policy's objectives, scope, and application

The key revisions include an expansion of the policy's scope to include those Federal Reserve Bank payments and securities settlement systems that meet the policy's application criteria, revised general risk management expectations for systems subject to the policy, and the incorporation of both the Core Principles for Systemically Important Payment Systems (Core Principles) and the Recommendations for Securities Settlement Systems (Recommendations)

The Core Principals were developed by the Committee on Payment and Settlement Systems (CPSS) of the central banks of the Group of Ten countries. The Recommendations were developed by the CPSS and the Technical Committee of the International Organization of Securities Commissions.

Proposed Rule to Retain Trust Preferred Securities

The Federal Reserve Board on May 6, 2004, requested public comment on a proposed rule that would retain trust preferred securities in the tier 1 capital of bank holding companies (BHCs), but with stricter quantitative limits and clearer qualitative standards

Under the proposal, after a three-year transition period, the aggregate amount of trust preferred securities and certain other capital elements would be limited to 25 percent of tier 1 capital elements, net of goodwill The amount of trust preferred securities and certain other elements in excess of the limit could be included in tier 2 capital, subject to restrictions. Internationally active BHCs would generally be expected to limit trust preferred securities and certain other capital elements to 15 percent of tier 1 capital elements, net of goodwill

Comments were requested by July 11, 2004.

The proposed revisions address supervisory concerns, competitive equity considerations, and recent changes in accounting for trust preferred securities under generally accepted accounting principles (GAAP) The proposal also would strengthen the definition of regulatory capital by incorporating longstanding policies that are not explicitly set forth in the Board's current capital guidelines

However, the proposal would not affect the way BHCs account for trust preferred securities on their regulatory reports filed with the Federal Reserve. Consistent with longstanding Federal Reserve direction, BHCs follow GAAP in accounting for these instruments for regulatory reporting purposes.

Adequacy of Existing Disclosures of Debit Card Fees

The Federal Reserve Board on May 18, 2004, announced that it will conduct a study on debit card fees and requested public comment on the adequacy of existing disclosures of such fees to consumers

Members of the Senate Banking, Housing, and Urban Affairs Committee asked the Board to study debit card fees imposed by financial institutions when their customers complete a point-of-sale debit transaction by providing their personal identification number, or PIN. This request reflected their concern that consumers may be unaware, or not adequately informed, that their bank may impose fees when the consumer chooses to use a PIN, rather than a signature, to authorize a transaction at point-of-sale.

The Electronic Fund Transfers Act (EFTA) sets forth the existing disclosure requirements governing electronic fund transfers (EFTs), and provides a basic framework for establishing the rights, liabilities, and responsibilities of participants in EFT systems. The types of transfers covered by the EFTA include transfers initiated through point-of-sale terminals, automated teller machines, and others The statute and its implementing regulation (Regulation E, Electronic Fund Transfers) require the initial disclosure of specified terms and conditions of an EFT service, including fees, and further require terminal receipts and periodic account activity statements

In connection with the study, the Board is soliciting comment on whether the existing disclosures required by the EFTA effectively make consumers aware of the imposition of debit card transaction fees by their financial institution when they choose to use a PIN The Board also seeks the public's views on the need for, and the potential benefits of, requiring additional disclosures in each periodic account activity statement to reflect such debit card fees.

This *Federal Register* solicitation of comment is one element of the broader study requested, in which the Board has also been asked to study the prevalence of debit card PIN-use fees being imposed, and the feasibility of requiring real-time disclosure of such fees at the point of sale, among other issues

Public comment on the specific issues identified will assist the Board in preparing the study and report that will be submitted to members of the Congress in November 2004.

Prescreened Solicitations for Credit or Insurance

The Federal Reserve Board on May 18, 2004, requested public comment on a Board study and a report to the Congress on prescreened solicitations for credit or insurance.

The Fair and Accurate Credit Transactions Act of 2003 (FACT Act), which generally amends the Fair Credit Reporting Act (FCRA), requires the Board to conduct a study concerning prescreened solicitations. Under the FCRA, creditors and insurers in specific

circumstances may use certain consumer reports as the basis for sending unsolicited offers of credit or insurance to consumers who meet certain criteria for credit worthiness or insurability (so-called *prescreened solicitations*)

The FCRA provides a mechanism by which consumers can elect not to receive these prescreened solicitations, by directing consumer reporting agencies to exclude the consumer's name and address from lists provided by these agencies to creditors or insurers for use in sending prescreened solicitations. Section 213(e) of the FACT Act requires the Board to conduct a study of the ability of consumers to avoid receiving these prescreened solicitations (including using the mechanism described above), and the potential effect of any further restrictions on providing consumers with such prescreened solicitations

The Board is requesting public comment on a number of issues to assist in preparation of the study and a report that the Board must submit to the Congress by December 4, 2004

Proposed Revisions to Bank Holding Company Rating System

The Federal Reserve on July 23, 2004, requested public comment on proposed revisions that would better align the bank holding company rating system with current supervisory practices.

The proposed rating system incorporates an increased emphasis on risk management, a more flexible and comprehensive evaluation of financial condition, and an explicit determination of the likelihood that the nondepository entities of a holding company will have a significant negative effect on the depository subsidiaries

Under the revised rating system, each holding company would be assigned a composite rating (C) based on an evaluation and rating of three essential components of an institution's financial condition and operations. risk management (R), financial condition (F), and potential impact (I) of the parent company and nondepository subsidiaries on the subsidiary depository institutions. A fourth component in the rating system, (D), would generally mirror the primary supervisors' assessment of the subsidiary depository institutions. (A simplified version of the rating system would be applied to noncomplex bank holding companies with assets of less than $1 billion.)

To provide a consistent framework for assessing risk management, the risk-management component is supported by four qualitatively rated subcomponents: competence of board and senior management; policies, procedures, and limits; risk monitoring and management information systems, and internal controls

The financial condition component is supported by four numerically rated subcomponents: capital adequacy, asset quality, earnings, and liquidity

The proposal also contains guidance on implementation of the revised rating system based on holding company size and complexity

BANK REGULATORY AGENCIES

Rollout Delayed of Web-Based Central Data Repository for Bank Financial Data

The federal banking agencies announced on July 22, 2004, that they would postpone the rollout of the Central Data Repository (CDR)—an Internet-based system created to modernize and streamline the way that the agencies collect, validate, and distribute financial data, or *Call Reports*, submitted by banks. Originally scheduled to be implemented on October 1, 2004, the system's start date will be delayed to address industry feedback and allow more time for testing and enrollment. A new timeline for implementation was announced in August

The decision to delay implementation of the CDR was made to address delays in system development and testing Moreover, the agencies had received an increasing number of questions and concerns about the new system from banks, industry trade associations, software vendors, and other stakeholders

Initial testing of the system demonstrated that the technology chosen is sound and that the XBRL standard underlying the system's framework will perform as required. However, Call Report data represent a critical source of information for the bank supervision process, and the banking agencies determined that a postponement was warranted

The agencies are considering alternative plans for the CDR rollout, including phasing in the new technology and business models in separate reporting quarters. For now, the agencies will continue to collect, validate, and manage Call Report data using their existing processing systems This includes the retention of Electronic Data Services Corporation as the agencies' electronic collection agent for Call Report data Accordingly, banks will continue filing their Call Report in the same manner until they are notified by the agencies to begin using the new CDR system

This initiative—the *Call Report Modernization Project*—is an interagency effort under the auspices of the Federal Financial Institutions Examination

Council (FFIEC). Additional project details and other important information are posted on the FFIEC's web site at www.FFIEC.gov/FIND

Issuance of Rules and Guidance

Rule on Use of Medical Information for Credit Eligibility

The federal bank, thrift institution, and credit union regulatory agencies on April 23, 2004, issued for publication in the *Federal Register* a proposed rule under the Fair Credit Reporting Act (FCRA) that would incorporate the statutory prohibition on obtaining or using medical information in connection with credit eligibility determinations and, as required by the statute, create certain exceptions to be applied in limited circumstances.

Section 411 of the Fair and Accurate Credit Transactions Act of 2003 (FACT Act) amends the FCRA to provide that a creditor may not obtain or use medical information in connection with any determination of a consumer's eligibility, or continued eligibility, for credit, except as permitted by regulations The FACT Act requires the agencies to prescribe regulations that permit creditors to obtain and use medical information for eligibility purposes when necessary and appropriate to protect legitimate operational, transactional, risk, consumer, and other needs. The FACT Act further provides that the regulations creating these exceptions would be issued in final form within six months of the date of enactment of the FACT Act, or June 4, 2004

As required by section 411, the proposed regulations would grant exceptions to allow creditors to obtain or use medical information in those circumstances that the agencies believe are necessary and appropriate in connection with determinations of consumer eligibility for credit

Section 411 of the FACT Act also amends the FCRA to limit the ability of creditors and others to share medical-related information with affiliates, except as permitted by the statute, regulation, or order. The proposed rule would enumerate situations in which creditors would be permitted to share medical information among affiliates.

The proposed rule was issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision The rules of each agency are substantively identical.

Guidance on Overdraft Protection Programs

The federal financial institutions supervisory agencies on May 28, 2004, issued proposed guidance to assist insured depository institutions in the responsible disclosure and administration of overdraft protection services.

The proposed guidance identifies concerns raised by institutions, financial supervisors, and the public about the marketing, disclosure, and implementation of overdraft protection programs To address these concerns, the proposed guidance: (1) seeks to ensure that financial institutions adopt adequate policies and procedures to address the credit, operational, and other risks associated with overdraft protection services; (2) alerts institutions offering these services to the need to comply with all applicable federal and state laws; and (3) sets forth examples of best practices that are currently observed in, or recommended by, the industry

The proposal is being issued under the auspices of the Federal Financial Institutions Examination Council (FFIEC) by its member agencies: the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

Rule on Affiliate Marketing Opt Outs

The federal financial institutions supervisory agencies on July 2, 2004, issued proposed regulations that would give consumers the chance to *opt out* before a financial institution uses information provided by an affiliated company to market its products and services to the consumer.

The proposed rulemaking would implement the affiliate marketing provisions in section 214 of the Fair and Accurate Credit Transactions Act of 2003 (FACT Act), which adds a new section 624 to the Fair Credit Reporting Act (FCRA). The proposal generally would prohibit an institution from using certain information about a consumer it receives from an affiliate to make a solicitation to the consumer unless the consumer has been given notice and an opportunity to opt out of the solicitation. An institution that has a pre-existing business relationship with the consumer would not be subject to this marketing limitation Nothing in the new affiliate marketing opt out supercedes or replaces the provisions in section 603 of the FCRA concerning the right to opt out of the sharing of information among affiliates,

although there is some overlap between the two opt out requirements

The proposal was issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

Final Rule on Capital Requirements for Asset-Backed Commercial Paper Programs

The federal banking and thrift institution regulatory agencies on July 20, 2004, issued a final rule amending their risk-based capital standards. The rule permits sponsoring banks, bank holding companies, and thrift institutions (banking organizations) to continue to exclude from their risk-weighted asset base, for purposes of calculating the risk-based capital ratios asset-backed commercial paper (ABCP) program, assets that are consolidated onto sponsoring banking organizations' balance sheets as a result of Financial Accounting Standards Board Interpretation No. 46, Consolidation of Variable Interest Entities, as revised (FIN 46R) This provision of the final rule will make permanent an existing interim final rule.

The final rule also requires banking organizations to hold risk-based capital against eligible ABCP liquidity facilities with an original maturity of one year or less that provide liquidity support to ABCP by imposing a 10 percent credit conversion factor on such facilities. Eligible ABCP liquidity facilities with an original maturity exceeding one year remain subject to the current 50 percent credit conversion factor. Ineligible liquidity facilities are treated as direct credit substitutes or recourse obligations and are subject to a 100 percent credit conversion factor. The resulting credit equivalent amount is then risk weighted according to the underlying assets, after consideration of any collateral, guarantees, or external ratings, if applicable. All liquidity facilities that provide liquidity support to ABCP will be treated as eligible liquidity facilities for a one-year transition period.

The rule, which will be published shortly in the *Federal Register*, becomes effective on September 30, 2004.

Bank Secrecy Act Examination Procedures

The federal financial institutions regulatory agencies on July 28, 2004, issued Bank Secrecy Act (BSA) procedures for examining each domestic and foreign banking organization's customer identification program (CIP), which is required by section 326 of the USA Patriot Act (codified in the BSA at 31 U.S C. 5318(*l*)) The procedures are designed to help financial institutions fully implement the new CIP requirements and facilitate a consistent supervisory approach among the federal financial institutions regulatory agencies.

The USA Patriot Act, signed into law on October 26, 2001, establishes new and enhanced measures to prevent, detect, and prosecute money laundering and terrorism. The regulation implementing section 326 of the act requires each financial institution to implement a written CIP that includes certain minimum requirements and is appropriate for its size and type of business. The CIP must be incorporated into the financial institution's anti-money laundering compliance program, which is subject to approval by the financial institution organization's board of directors

Compliance with the regulation was required by October 1, 2003.

Regulatory Agencies Request Comment

Statement Concerning Complex Structured Finance Activities

Five federal agencies on May 14, 2004, requested public comment on a proposed statement describing internal controls and risk management procedures that the agencies believe will assist financial institutions that engage in complex structured finance activities to identify and address the risks associated with such transactions.

As recent events have highlighted, a financial institution may assume substantial reputational and legal risk if the institution enters into a complex structured finance transaction with a customer and the customer uses the transaction to circumvent regulatory or financial reporting requirements, evade tax liabilities, or further other illegal or improper behavior.

The interagency statement describes the types of internal controls and risk management procedures that should help financial institutions effectively manage and address the reputational, legal, and other risks associated with their complex structured finance activities and operate in accordance with applicable law The statement, among other things, provides that financial institutions engaged in complex structured finance activities should have effective policies and procedures in place to

• identify those complex structured finance transactions that may involve heightened reputational and legal risk;
• ensure that these transactions receive enhanced scrutiny by the institution, and
• ensure that the institution does not participate in illegal or inappropriate transactions

The statement also emphasizes the critical role of an institution's board of directors and senior management in establishing a corporate-wide culture that fosters integrity, compliance with the law, and overall good business ethics

The proposed statement was issued by the Securities and Exchange Commission, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. The statement would represent supervisory guidance for institutions supervised by the four banking agencies and a policy statement for institutions supervised by the Securities and Exchange Commission

On June 18, 2004, the five federal agencies agreed to extend for thirty days the comment period on the proposed Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities, published in the *Federal Register* on May 19, 2004

In a letter submitted to the five agencies on June 10, 2004, eight trade associations representing financial institutions asked the agencies to provide the public with an additional thirty-day period to review, analyze, and submit comments on the proposed interagency statement.

The extended public comment period on the interagency statement ended July 19, 2004. The scope and comment process for the interagency statement remained as stated in the original *Federal Register* notice of May 19, 2004

Disposal of Consumer Information

The federal bank and thrift institution regulatory agencies on June 8, 2004, invited public comment on an interagency proposal to require financial institutions to adopt measures for properly disposing of consumer information derived from credit reports

Current law requires financial institutions to protect customer information by implementing information security programs The proposed rules would require institutions to make adjustments to their information security programs to properly dispose of the types of consumer information that are not already protected This would include information from credit reports about a financial institution's employee or about an individual whose application for a product or service is denied.

The agencies' proposal implements section 216 of the Fair and Accurate Credit Transactions Act of 2003 (FACT Act) Although not imposing significant additional burden, the proposed rules would make amendments to include this new statutory requirement in the *Interagency Guidelines Establishing Standards for Safeguarding Customer Information*, which were adopted in 2001 The agencies' proposed rules add a new definition of *consumer information* and a provision to require financial institutions to implement appropriate measures to properly dispose of consumer information.

The proposal would take effect three months after a final rule is adopted.

BOARD BEGINS 2004 SURVEY OF CONSUMER FINANCES

The Federal Reserve Board announced on May 25, 2004, that in June, it would begin a statistical study of household finances, the Survey of Consumer Finances, that will provide policymakers with important insight into the economic condition of all types of American families.

The survey, undertaken every three years since 1983, is being conducted for the Board by NORC, a social science research organization at the University of Chicago, through December 2004.

The data collected will provide a representative picture of what Americans own—from houses and cars to stocks and bonds—how and how much they borrow and how they bank Past study results have been important in policy discussions regarding pension and social security reform, tax policy, deposit insurance reform, and a broad range of other areas.

"Although good overall information on the state of the major sectors of the economy is available regularly, our knowledge about the financial circumstances faced by different types of households is much more limited," Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, said in a letter to prospective survey participants. "Our survey fills a key part of this gap," he said

The 2004 survey will contain a new section on the pension entitlements that families have Earlier versions of the survey have collected data separately on traditional defined-benefit pension plans and account-

based plans, such as 401(k) accounts. In recent years, classification and measurement of pensions have been complicated by the growth of pension arrangements that combine aspects of both types of plans—particularly defined benefit plans with a specified cash settlement option in lieu of regular retirement payments, such as in a *cash balance plan.* The new question sequence will focus more on attributes of plans instead of asking the survey participants to make rigid distinctions between abstract types of plans that they may not understand fully

Participants in the study are chosen at random from seventy-nine areas across the United States, using a scientific sampling procedure A representative of NORC contacts each potential participant personally to explain the study and request time for an interview.

"Let me assure you that protecting the privacy of survey participants has the highest priority in our data collection system," Mr. Greenspan said. NORC uses names and addresses only for the administration of the survey, and that identifying information will be destroyed at the close of the 2004 study. NORC is required never to give the names and addresses of participants to anyone at the Federal Reserve or anywhere else

Information provided by survey participants is also protected by the Confidential Information Protection and Statistical Efficiency Act of 2002. This act prohibits the Federal Reserve or any of its employees or agents (including NORC) from using the information provided by a participant for any nonstatistical purpose, or from disclosing the information in a way that would identify the participant without the participant's consent. To help ensure compliance, the act includes strong criminal penalties for any person that violates the act's protections.

Summary results for the 2004 study will be published in early 2006 after all data from the survey have been assessed and analyzed.

Board Begins Survey of Small Business Finances

The Federal Reserve Board on June 10, 2004, announced that it had begun the latest Survey of Small Business Finances in June 2004, the fourth in a series since 1988 aimed at increasing policymakers' understanding of the ways economic and regulatory changes affect small firms' access to credit.

On behalf of the Board, NORC (a social science research organization at the University of Chicago) is collecting information from small businesses about their finances in 2003 Through the end of 2004, it will conduct telephone interviews with 4,000 executives at firms of fewer than 500 employees

In a letter, Federal Reserve Chairman Alan Greenspan encouraged the business owners that were randomly selected for the survey to participate, noting that the data collected by past surveys have been critical for policy decisions at the Federal Reserve and in other parts of government.

"The Federal Reserve Board is concerned with the ways in which economic and regulatory changes affect small businesses. . . . Such changes can, in turn, have important implications for economic policymaking," he wrote

The last survey collected information on small business finances in 1998. Both the state of the economy and the use of technology are very different today than they were then. The Board plans to publish findings from the new study in early 2006 after all the data have been collected and analyzed.

Participants are randomly selected from all fifty states and the District of Columbia using scientific sampling methods They will be asked about their use of credit and other financial services and their experience in obtaining credit during 2003 Information will be collected about firms' assets, liabilities, income, and expenses.

Participation is voluntary but a broad sample will help government policymakers more clearly understand the effect of their actions on small businesses The names and addresses of participants and any other identifying information will be held in the strictest confidence Information provided by survey participants is also protected by the Confidential Information Protection and Statistical Efficiency Act of 2002 This act prohibits the Federal Reserve or any of its employees or agents (including NORC) from using the information provided by a participant for any nonstatistical purpose, or from disclosing the information in a way that would identify the participant without the participant's consent. To help ensure compliance, the act includes strong criminal penalties for any person that violates the act's protections.

More information is available on the Federal Reserve's web site at www.federalreserve gov/ssbf or NORC's site at www.norc uchicago edu/ssbf

Federal Reserve Banks Announce Strategy to Meet Evolving Demands of Payments System

The Federal Reserve Banks on June 16, 2004, announced a strategy to accommodate the evolution

of the nation's payments system from paper check processing to electronic processing, a development driven by a significant broad-based change in user preference. The Reserve Banks' strategy entails launching new products and services to support the implementation of the Check 21 Act in October 2004, as well as streamlining its check-processing infrastructure by discontinuing check processing at locations to be announced later this year. Even with these changes, the Federal Reserve Banks will continue to provide check-processing services on a national basis.

In this effort, Reserve Banks will provide opportunities through their Check 21 products and services for financial institutions to make use of electronic check services as a means of reducing their overall check operating costs. These steps should also reduce the time during which industry participants and the Reserve Banks must support significant investments in dual processing platforms.

"These steps are part of a forward-looking strategy that acknowledges the financial services industry's ongoing evolution from paper to electronic processing," said Gary Stern, President of the Federal Reserve Bank of Minneapolis and Chairman of the Reserve Banks' Financial Services Policy Committee. "This shift is good for consumers and good for the financial services industry, and the Fed has encouraged this evolution for a number of years. As the payments system moves to accommodate more electronic options, the Fed will embrace a strategy that will respond to the marketplace as necessary."

As part of this strategy, the Reserve Banks will also undertake a thorough annual review of their existing check-processing infrastructure, including potentially discontinuing paper check processing at some locations as the market evolves. Currently, the Reserve Banks are examining their existing check facilities and within the next few months will announce the discontinuation of some additional check-processing facilities through 2005.

The criteria for decisions about infrastructure changes will closely parallel those used in the Reserve Banks' check reengineering initiative announced in 2003, and will rely on an evaluation of volume levels, business retention plans, effects on local markets, and other data. Last year, the Federal Reserve announced a restructuring of its check-processing operations from forty-five to thirty-two sites by year-end 2004.

In 2003, Reserve Banks' check volume declined at about a 5 percent rate. For 2004, check volumes have declined at an accelerated pace compared to the same period last year. A 2001 Federal Reserve study revealed that about 42 billion checks were written that year in the United States, considerably lower than industry estimates. Those volumes are expected to continue to decline in coming years. The Reserve Banks will continue to assist the nation's financial services industry by conducting research related to the nation's payments system. The results of the most recent study will be available later this year.

"The Federal Reserve Banks are committed to their role in providing payments services, and that means responding to the changing demands of the industry," Stern said.

This long-term check-processing strategy will allow the Reserve Banks to better meet the expectations of the 1980 Monetary Control Act. That act requires the Reserve Banks to set prices to recover, over the long run, their total operating costs of providing payment services to depository institutions, as well as the imputed costs they would have incurred and the imputed profits they would have expected to earn had the services been provided by a private business firm.

"To date, the transfer of Fed check-processing activities to other Fed sites has occurred smoothly, with deposit times and availability transitioning as close to existing service levels as possible," Stern said. "We expect a smooth transition for the next round of restructuring."

As before, the Reserve Banks will offer a variety of programs to affected staff. These programs include separation packages, extended medical coverage, and career transition assistance.

"While the changes in payments technology are good for consumers and make the industry more efficient, these changes mean that the Reserve Banks will be losing dedicated management and staff," Stern said. "While regrettable, these job reductions are an outgrowth of change, and the Reserve Banks will do their best to make this transition as smooth as possible for affected employees."

Appointment of Jeffrey M. Lacker as President, Federal Reserve Bank of Richmond

Jeffrey M. Lacker has been appointed president of the Federal Reserve Bank of Richmond, effective August 1, 2004. He succeeds J. Alfred Broaddus, Jr., who last November, announced his intention to retire. Lacker is currently senior vice president and director of research at the Federal Reserve Bank of Richmond.

The appointment was made by the Board of Directors of the Federal Reserve Bank of Richmond and

approved by the Board of Governors of the Federal Reserve System in Washington, D.C. Wesley S. Williams, Jr., Chairman of the Federal Reserve Bank of Richmond's Board of Directors, made the announcement on June 17, 2004.

Commenting on the announcement, Williams said,

> "After conducting a nationwide search, I am pleased to say that Jeff Lacker, the Bank's current director of research, proved to be a natural choice to lead the Federal Reserve Bank of Richmond. Jeff is a respected economist with sound knowledge of monetary policy, the nation's banking system, and the Federal Reserve's role in the payments system. Jeff has the rare combination of knowledge and Federal Reserve experience to provide the vision needed in facing the challenges of the future. Additionally, he is a brilliant manager, and is uniquely attuned to the community development responsibilities of the Federal Reserve Banks and System. My colleagues on the Richmond Fed board concluded that Jeff was clearly the best possible choice to carry forward the laudable traditions of this great institution, and to serve our Fifth District communities."

Williams also expressed appreciation to Al Broaddus for his thirty-four years of service to the Federal Reserve Bank of Richmond, and for his countless contributions to the Federal Reserve System. Broaddus turned sixty-five in July, the age at which Federal Reserve Bank presidents usually retire.

> "It has been a great pleasure working with Al Broaddus," Lacker said. "He leaves behind an outstanding legacy of contributions to monetary policy, the Richmond Fed, and the Federal Reserve System. I am honored to have been chosen for this post, and I look forward to working with community, business, and banking leaders around the District."

Lacker is only the seventh person to lead the Richmond Federal Reserve Bank in its ninety-year history.

> "I have known and worked closely with Jeff for many years," Broaddus said. "He is a strong and collegial leader and an excellent economist. He is a superb choice to lead our Bank on the next stage of its long journey of distinguished public service."

Jeff Lacker, forty-eight, is a graduate of Franklin and Marshall College and received a Ph.D. in economics from the University of Wisconsin. Lacker was an assistant professor of economics at the Krannert School of Management, Purdue University, from 1984 to 1989. He joined the Bank in 1989 as an economist in the banking area of the Research Department. Lacker was named research officer in 1994, vice president in 1996, and senior vice president and director of research in May 1999.

Federal Open Market Committee Schedule for 2005

The Federal Open Market Committee on June 25, 2004, announced its tentative meeting schedule for 2005: February 1–2 (Tuesday–Wednesday), March 22, May 3, June 29–30 (Wednesday–Thursday), August 9, September 20, November 1, and December 13, 2005, and January 31–February 1, 2006 (Tuesday–Wednesday).

United States Unveils New $50 Note

U.S. government officials from the Department of the Treasury, the Federal Reserve, and the United States Secret Service, on April 26, 2004, unveiled the new $50 note design with enhanced security features, subtle background colors of blue and red, images of a waving American flag, and a small metallic silver-blue star.

The new design is part of the government's ongoing efforts to stay ahead of counterfeiting and to protect the integrity of U.S. currency. The new $50 note, which is planned to be issued in late September or early October, is the second denomination in the Series 2004 currency. The first was the $20 note, which began circulating in October 2003.

"U.S. currency is a worldwide symbol of security and integrity. These new designs help us keep it that way, by protecting against counterfeiting and making it easier for people to confirm the authenticity of their hard-earned money," U.S. Treasury Secretary John W. Snow said. "In addition to keeping our currency safe from counterfeiters, the President's economic policies are ensuring that more of those dollars stay in the pockets of American families."

Snow was joined at the unveiling of the new $50 note's design by Federal Reserve Board Governor Mark W. Olson, Tom Ferguson, Director of the Treasury's Bureau of Engraving and Printing, which produces U.S. currency, and C. Danny Spriggs, Deputy Director of the United States Secret Service, the law enforcement agency responsible for combating counterfeiting.

The new $50 note was unveiled at the Bureau of Engraving and Printing's Western Currency Facility (WCF) in Fort Worth, Texas, and the occasion also marked the grand opening of the WCF's new Visitor Center. The Visitor Center, which plans to welcome

500,000 guests annually, offers free tours to the public five days a week since opening on April 27, 2004, and provides a much anticipated tourism draw to the Dallas–Fort Worth community. At the Visitor Center, guests enjoy tours of the production facility, learn about the technology and history of U.S. currency through interactive displays, and purchase money-themed items and souvenirs in the gift shop.

The WCF, which prints 55 percent of all U.S. paper currency, is the only location other than the Bureau's Washington, D.C., facility that prints the nation's currency, and it will also be printing the first run of the newly redesigned $50 note.

The new $50 notes will be safer, smarter, and a more secure currency: safer because they will be harder to fake and easier to check, smarter to stay ahead of tech-savvy counterfeiters, and more secure to protect the integrity of U.S. currency.

"We want the public to know how to use the security features to protect their hard-earned money," said Spriggs. "The combined efforts of public education, aggressive law enforcement, and improved currency security features have increased public awareness and have helped in the fight against counterfeiting."

Despite counterfeiters' increasing use of technology, advanced counterfeit deterrence efforts on the part of the authorities have kept counterfeiting at low levels. Current estimates put the rate of counterfeit $50 notes in circulation worldwide at less than one note for every 25,000 genuine $50 notes in circulation.

"A sound currency, which this new $50 note will foster, is a pivotal factor in the strength of our economy," said Olson. He said that preparations for issuing the new $50 note will include educational outreach to businesses, financial institutions, and consumers that use the denomination most. "Our objective is a smooth transition for the newly designed currency into daily cash transactions. For that to happen, it must be recognized and honored as legal tender, and those who use it and handle it must know how to verify its authenticity."

The $50 note will be followed later by a new $100 note. Decisions on new designs for the $5 and $10 notes are still under consideration, but a redesign of the $1 and $2 notes is not planned. Even after the new money is issued, older-design notes will remain legal tender.

Because counterfeiters are turning increasingly to digital methods and as advances in technology make digital counterfeiting easier and cheaper, the government is staying ahead of counterfeiters by updating the currency every seven to ten years.

"We have to stay ahead of technology, which is developing and progressing at an ever-increasing rate. Items like digital printers and higher quality scanners are becoming more readily available at cheaper prices," said Ferguson. "So we have to make our currency notes safer, smarter, and more secure in order to stay ahead of the would-be counterfeiters."

The New Color of Money

Although consumers should not use color to check the authenticity of their currency (relying instead on user-friendly security features), color does add complexity to the note, making counterfeiting more difficult. Different colors will be used for different denominations, which will help everyone—particularly those who are visually impaired—to tell denominations apart.

The new notes feature subtle background colors and highlight historical symbols of Americana. The $50 note, which will be issued in late 2004, includes subtle background colors of blue and red, and images of a waving American flag and a small metallic silver-blue star.

Security Features

The new $50 design retains three important security features that were first introduced in the 1990s and are easy for consumers and merchants alike to check:

- watermark: a faint image, similar to the portrait, which is part of the paper itself and is visible from both sides when held up to the light.
- security thread: also visible from both sides when held up to the light, this vertical strip of plastic is embedded in the paper and spells out the denomination in tiny print.
- color-shifting ink: the numeral in the lower right corner on the face of the note, indicating its denomination, changes color when the note is tilted.

Because these features are difficult for counterfeiters to reproduce well, they often do not try. Counterfeiters are hoping that cash-handlers and the public will not check their money closely.

Counterfeiting: Increasingly Digital

Counterfeiters are increasingly turning to digital methods, as advances in technology make digital

counterfeiting of currency easier and cheaper In 1995, less than 1 percent of counterfeit notes detected in the United States were digitally produced Since then, digital equipment has become more readily available to the general public, and as a result, the amount of digitally produced counterfeit notes has risen Over the past several years, the amount of digitally produced counterfeit notes has remained steady at about 40 percent

Law enforcement has remained aggressive. In 2003, the United States Secret Service made 469 seizures of digital equipment involved in currency counterfeiting, such as personal computers, and made more than 3,640 arrests in the United States for currency counterfeiting activities The conviction rate for counterfeiting prosecutions is about 99 percent

Public Education

Public recognition of the currency features, which increased to 85 percent in the United States as a result of the public education effort for the new $20 note, is an important factor in counterfeit deterrence

Because the improved security features are more effective if the public knows about them, the U.S government is undertaking a broad public education program This program will ensure that people all over the world know the new currency is coming, and help them recognize and use the security features The outreach will include cash-handlers, merchants, business and industry associations, and the media There is nearly $700 billion in circulation worldwide and as much as two-thirds of U.S. currency is held outside the United States, therefore, the public education program will extend worldwide.

To learn more about the new currency and to download images of the new currency designs, visit www moneyfactory com/newmoney.

BUSINESSES, BANKS, AND CASH-HANDLING EQUIPMENT MANUFACTURERS GET FINAL ALERT TO PREPARE FOR NEW $50 NOTE

Treasury and Federal Reserve Announce Safer, Smarter, More Secure $50 Note to Begin Circulating September 28, 2004

The newly redesigned Series 2004 $50 notes, featuring subtle background colors of blue and red, images of a waving American flag, and a small metallic silver-blue star, will be issued beginning on September 28, 2004, the U.S government announced on June 30, 2004 On the day of issue, the Federal Reserve Banks will begin distributing the new notes to the public through commercial banks

The June 30, 2004, announcement of the $50 note's day of issue signals to banks and businesses that they should make final preparations for the new notes For some businesses, preparations include training cash-handling employees on how to use the notes' security features, for others it entails making technical adjustments to ATMs or machines with cash receptors, such as vending or automated checkout machines.

"The enhanced security features in this series of notes help ensure that U.S. currency will continue to represent the trust, value, and confidence that people all over the world have grown to rely on and expect," said Federal Reserve Board Governor Mark W Olson "As always, all new notes will co-circulate with the older designs. All notes are good for good."

"The objective of the new currency program is a safer, smarter, and more secure currency and its smooth transition into daily commerce," said Tom Ferguson, Director of the Treasury's Bureau of Engraving and Printing (BEP) "To that end, we have been working with the appropriate machine manufacturers for nearly two years to ensure they have the information they need to make their equipment compatible with each newly redesigned note that is introduced into circulation."

Public Education

A variety of training materials—such as posters, training videos, and brochures—is available in twenty-four languages The materials can be downloaded or ordered through www moneyfactory.com/newmoney

Since the Treasury's Bureau of Engraving and Printing (BEP) began taking orders in May 2003, more than 46 million pieces of training materials have been ordered by businesses and other organizations to help them train their cash-handling employees about the notes' enhanced security features

Additional text that appeared in this press release was also stated in the announcement released on April 26, 2004, "United States Unveils New $50 Note," which appears on page 340 of this issue.

PUBLICATION OF REVISED CAPITAL FRAMEWORK AND U.S IMPLEMENTATION PLANS

The Basel Committee on Banking Supervision on June 26, 2004, released its document "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" The Framework (also referred to as Basel II) represents the outcome of the work of the Basel Committee, with active participation by the United States banking and thrift institution agencies (Agencies), over recent years to secure international convergence on revisions to regulations and standards governing the capital adequacy of internationally active banking organizations. The Framework will form the basis upon which the Agencies, and representatives of the other Basel Committee member countries, develop proposed revisions to existing capital adequacy regulations and standards

The Framework is available on the Basel Committee's web site at www.bis.org, the Office of the Comptroller of the Currency's (OCC) web site at www.occ.treas.gov, the Federal Reserve Board's (Federal Reserve) web site at www federalreserve.gov, the Federal Deposit Insurance Corporation's (FDIC) web site at www fdic gov, and the Office of Thrift Supervision's (OTS) web site at www ots.treas gov.

U.S. Implementation Plans

As noted, the Framework would form the basis upon which the Agencies develop proposed revisions to their existing risk-based capital adequacy regulations. As previously announced, the Agencies expect that only a small number of large, internationally active U S banking organizations would be required to use the Framework, and that those institutions would use only the most advanced approaches for determining their risk-based capital requirements. Application of the Framework's advanced approaches to other qualifying U.S banking organizations would be at the banking organization's option

The Agencies have developed a comprehensive plan to incorporate the advanced risk and capital measurement methodologies of the Framework into regulations and supervisory guidance for U S institutions. This plan would ensure that U S implementation efforts are consistent with the Framework; reflect the unique statutory, regulatory, and supervisory processes in the United States; and appropriately seek and consider comments on individual aspects of the plan from all interested parties

Before implementation, it is expected that institutions using Framework-based regulations and guidance will first be subject to a year of *parallel running;* for example, application of the advanced approaches in tandem with the current risk-based capital regime, beginning in January 2007 The Agencies anticipate that the Framework would become fully effective in the United States in January 2008. The Agencies plan to apply prudential floors to risk-based regulatory capital calculations in the two years immediately after adoption of the Framework. Qualified institutions that opt in to the Framework subsequent to the initial implementation period would be subject to a similar phase-in schedule (for example, parallel running and floors).

Given the investments needed to qualify for the advanced approaches of the Framework, the Agencies believe that it would be prudent for banking organizations that expect to adopt the Framework on or near the effective date to begin planning their implementation efforts. To facilitate such efforts, the Agencies have described below the significant milestones in the development of Framework-based regulations, guidance, and policies Additional information on these activities will be forthcoming

Supervisory Guidance

The Agencies are developing supervisory guidance for various portfolios and risk exposures addressed by the Framework This guidance is intended to provide U.S institutions and supervisors with a clear description of the essential components and characteristics of the measurement and management structure for these risks and to describe relevant supervisory expectations for banking organizations adopting a Framework-based process for the determination of minimum regulatory risk-based capital requirements

The Agencies have previously published, for notice and comment, draft supervisory guidance on Internal Ratings-Based Systems (IRB) for Corporate Credit and on the Advanced Measurement Approaches (AMA) for Operational Risk. See 68 *Federal Register* 45949 (August 4, 2003). The Agencies expect to publish, for notice and comment, draft supervisory guidance on IRB Systems for Retail Credit in the third quarter of 2004 Over the course of the next year, the Agencies will publish for comment additional guidance on other aspects of IRB Systems

Institutions that expect to adopt the Framework are encouraged to consider the supervisory standards

articulated in the guidance in developing their implementation plans for the adoption of Framework-based systems. Specifically, institutions should begin to self-assess the extent to which their systems and processes comply with or differ from proposed supervisory standards. The Agencies expect to publish additional information regarding the process that will be used to assess individual institutions' efforts to meet IRB and AMA qualifying standards

Additional Quantitative Impact Study

Later, the Agencies will conduct a fourth Quantitative Impact Study (QIS-4) to evaluate the potential effects of a U.S. implementation of the Framework. QIS-4 will assist banking organizations and their supervisors in better understanding the implications of this proposal on the regulatory capital requirements of individual institutions and may provide some insight with regard to the competitive implications of the new rules. A full or partial recalibration of the Framework may be considered based on the results of the QIS-4 exercise.

Although other countries may undertake joint or independent reviews similar to QIS-4, the forthcoming study, as implemented in the United States, will be tailored to the domestic interests of the Agencies and will focus on the effect of the proposal on U.S banking organizations, especially those large internationally active institutions that the Agencies have proposed to require to conform to Framework-based regulations. Other institutions that anticipate adhering to Framework-based regulations on a voluntary basis may also participate in the study in order to understand better the nature of the internal risk measurement information that the new rules would require and to estimate their resulting capital requirements

As before, the Agencies will request that participants submit requested information by completing a series of computerized spreadsheets—the Agencies will ensure consistency in responses through detailed instructions, questionnaires, and supervisory oversight The Agencies expect to finalize and distribute survey materials to participating institutions in October 2004 and to request that institutions complete and return the survey results by mid-January 2005 Institutions that want to participate in the study were advised to discuss the project with their federal supervisor(s) by the end of July 2004.

Revision of Capital Adequacy Regulations

In August 2003, the Agencies published for notice and comment an advance notice of proposed rulemaking (ANPR), discussing possible revisions to U.S. risk-based capital adequacy regulations relating to an earlier iteration of the Framework. See 68 *Federal Register* 45900 (August 4, 2003). With the publication of the Framework, the Agencies will continue this rulemaking process.

As provided in the ANPR, the Agencies expect that some U S banking organizations would use the most advanced approaches set forth in the Framework to determine their risk-based capital requirements, while others would continue to apply the existing capital rules. As a result, the United States would have a bifurcated regulatory capital framework. In conjunction with the assessment of U S. risk-based capital adequacy regulations relating to the Framework, the Agencies are assessing possible changes to capital regulations for U S institutions that are not subject to Framework-based regulations.

Importantly, all U S. banking organizations would continue to be subject to a leverage ratio requirement under existing regulations, and Prompt Corrective Action (PCA) legislation and implementing regulations would remain in effect.

The Agencies expect that a notice of proposed rulemaking on possible revisions to risk-based capital adequacy regulations relating to the Framework will be published in mid-2005. After fully considering all comments, the Agencies expect to be in a position to publish final rules on this proposal in the second quarter of 2006. Possible changes to capital regulations for U.S institutions that are not subject to the Framework-based regulations would be considered and addressed in this same general timeframe.

PUBLICATION OF THE MAY 2004 UPDATE TO THE *COMMERCIAL BANK EXAMINATION MANUAL*

The May 2004 update to the *Commercial Bank Examination Manual* has been published (Supplement No. 21), and the publisher has sent copies to each Reserve Bank for distribution to examiners and other staff members. The new supplement includes supervisory and examination guidance on the following subjects.

1 *Rules on the Authority to take Disciplinary Actions against Independent Accountants and Accounting Firms that Perform Audit and Attestation Services* The federal

banking agencies (the agencies) jointly issued rules, as implemented by 12 CFR 363, that govern the agencies' authority to take disciplinary actions against independent accountants and accounting firms that perform audit and attestation services that are required by section 36 of the Federal Deposit Insurance Act See the Board's August 8, 2003, press release

Attestation services address management's assertions concerning internal controls over financial reporting by an independent public accountant A federally insured depository institution must include the accountant's audit and attestation reports in its annual report The rules, effective October 1, 2003, established procedures under which the agencies can, for good cause, remove, suspend, or bar an accountant or firm from performing audit and attestation services for federally insured depository institutions with assets of $500 million or more

2 *Mortgage Banking* The loan portfolio management section was revised to provide references to accounting pronouncements (that are consistent with the bank Call Report's instructions) that apply to mortgage banking transactions and activities Also, comprehensive mortgage banking examination procedures are provided in the manual's appendix, inclusive of the examination procedures and valuation concerns found in the February 25, 2003, Interagency Advisory on Mortgage Banking, "Risk Management and Valuation of Mortgage Servicing Assets Arising from Mortgage Banking Activities", the mortgage banking examination modules, and many of the inspection (examination) procedures found in the mortgage banking section 3070 0 of the *Bank Holding Company Supervision Manual* See SR letter 03-4

3 *Interagency Statement on Independent Appraisal and Evaluation Functions* The section on real estate appraisals and evaluations and the respective examination procedures and internal control questionnaire were revised to incorporate this October 27, 2003, interagency statement The statement emphasizes that a banking institution's board of directors is responsible for reviewing and adopting policies and procedures that establish and maintain an effective, independent real estate appraisal and evaluation program (the program) for all of its lending functions Concerns about the independence of appraisals and evaluations arise from the risk that improperly prepared appraisals may undermine the integrity of credit-underwriting processes An institution's lending functions should not have undue influence that might compromise the program's independence See SR letter 03-18

4 *Interagency Policy on Banks and Thrift Institutions Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates* New sections discuss this January 5, 2004, policy that alerts banking organizations, including their boards of directors and senior management, of the safety-and-soundness implications of and the legal impediments to a bank providing financial support to investment funds advised by the bank, its subsidiaries, or affiliates (that is, an affiliated investment fund)

The interagency policy emphasizes the following three core principles A bank should not (1) inappropriately place its resources and reputation at risk for the benefit of affiliated investment funds' investors and creditors, (2) violate the limits and requirements contained in Federal Reserve Act sections 23A and 23B and Regulation W, other applicable legal requirements, or any special supervisory condition imposed by the agencies, or (3) create an expectation that the bank will prop up the advised fund (or funds) See SR letter 04-1

5 *Foreign Banking Offices and Organizations* The section on bank-related organizations was revised to include brief definitions and descriptions on limited Regulation K authorized activities and services that are applicable to foreign bank offices and organizations (that is, foreign bank branches, agencies, commercial lending companies, representative offices, and correspondent banks) Also, for the purposes of sections 23A and 23B, the definition of affiliate was further clarified and expanded based upon the provisions of the Board's Regulation W

A more detailed summary of changes is included with the update package Copies of the new supplement were shipped directly by the publisher to the Reserve Banks for the distribution to examiners and other System staff The public may obtain the *Manual* and the updates (including pricing information) from Publications Fulfillment, Mail Stop 127, Board of Governors of the Federal Reserve System, Washington, DC 20551 (or charge by facsimile at 202-728-5886) The *Manual* is also available on the Board's public web site at www federalreserve.gov/boarddocs/supmanual/

PUBLICATION OF THE JUNE 2004 UPDATE TO THE *BANK HOLDING COMPANY SUPERVISION MANUAL*

The June 2004 update to the *Bank Holding Company Supervision Manual,* Supplement No 26, has been published and is now available. The *Manual* comprises the Federal Reserve System's regulatory, supervisory, and inspection guidance for bank holding companies (BHCs). The new supplement includes supervisory and BHC inspection guidance on the following subjects:

1 *Filing a Required Change in Control Notice* The Control and Ownership (Change in Control) section is revised to emphasize that any person (acting directly or indirectly) seeking to acquire control of a state member bank (SMB) or BHC should understand the requirements for filing a notice under the Change in Bank Control Act The complexity of an ownership position sometimes does not lend itself to easy interpretation of the requirements to file a notice When it is unclear whether a notice is required, the potential filer (or filers) or the affected SMB or BHC is encouraged to contact staff at a Federal Reserve Bank or the Board for guidance

Prior notice is required by any person (defined in the section) that seeks to acquire control of an SMB or BHC.

Control of a banking organization occurs whenever a person acquires ownership, control, or the power to vote 25 percent or more of any class of voting securities of the institution. Section 225.41 of Regulation Y (12 CFR 225.41), details the specific types of transactions that require prior notice under the Change in Bank Control Act. Certain other "rebuttable" presumptions of control are outlined in section 225.41, which may also require the filing of a notice, including (under certain circumstances) a proposed acquisition that would result in the person owning or controlling the power to vote 10 percent or more of any class of voting securities. See SR letter 03-19.

2. *Joint Rules on the Authority to take Disciplinary Actions against Independent Accountants and Accounting Firms that Perform Audit and Attestation Services.* The federal banking agencies (the agencies) jointly issued rules, as implemented by 12 CFR 363, that govern the agencies' authority to take disciplinary actions against independent accountants and accounting firms that perform audit and attestation services that are required by section 36 of the Federal Deposit Insurance Act. See the Board's August 8, 2003, press release.

Attestation services address management's assertions concerning internal controls over financial reporting by an independent public accountant. A federally insured depository institution must include the accountant's audit and attestation reports in its annual report. The rules established, effective October 1, 2003, the practices and procedures under which the agencies can, for good cause, remove, suspend, or bar an accountant or firm from performing audit and attestation services for federally insured depository institutions that have total assets of $500 million or more.

3. *Enhanced Framework for the Supervision of Consumer Compliance Risk.* The section on the risk-focused supervisory framework for large complex banking organizations (LCBOs) has been revised to incorporate this new guidance that was developed by the Board's Division of Banking Supervision and Regulation and its Division of Consumer and Community Affairs. The guidance applies to LCBOs and large banking organizations (LBOs) that are subject to the Federal Reserve System's continuous supervision program. Under this guidance, consumer compliance examiners, working in conjunction with the safety and soundness examiners, are to incorporate the banking organization's consumer compliance risk assessment into its overall risk assessment and planned supervisory activities for LCBOs and LBOs. See SR letter 03-22.

4. *Interagency Policy on Banks and Thrift Institutions Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates.* The January 5, 2004, interagency policy alerts banking organizations, including their boards of directors and senior management, of the safety-and-soundness implications of, and the legal impediments to, a bank providing financial support to investment funds advised by the bank, its subsidiaries, or its affiliates (that is, an affiliated investment fund).

The interagency policy emphasizes three core principles: a bank should not (1) inappropriately place its resources and reputation at risk for the benefit of an affiliated investment fund's investors and creditors, (2) violate the limits and requirements contained in the Federal Reserve Act's sections 23A and 23B, Regulation W, other applicable legal requirements, or in any special supervisory condition imposed by the agencies, or (3) create an expectation that the bank will support the advised fund (or funds).

In addition, bank-affiliated investment advisers are encouraged to establish alternative sources of financial support to avoid seeking support from affiliated banks. A bank's investment advisory services can pose material risks to the bank's liquidity, earnings, capital, and reputation and can harm investors, if the risks are not effectively controlled. Bank management is expected to notify and consult with its appropriate federal banking agency before (or immediately after, in the event of an emergency) providing material financial support to an affiliated investment fund. The inspection objectives and inspection procedures have been developed to focus on a BHC's oversight responsibilities for its bank and nonbank subsidiaries that advise investment funds. See SR letter 04-1.

5. *Interagency Statement on Independent Appraisal and Evaluation Functions.* The section on real estate appraisals and evaluations has been updated to incorporate this October 27, 2003, interagency statement. The statement emphasizes that a banking institution's board of directors is responsible for reviewing and adopting policies and procedures that establish and maintain an effective, independent real estate appraisal and evaluation program for all of its lending functions. Concerns about the independence of appraisals and evaluations arise from the risk that improperly prepared appraisals may undermine the integrity of credit-underwriting processes. See SR letter 03-18.

6. *Nonbanking Activities.* The sections on engaging in *EDP Servicing Company Activities* and activities involving *Electronic Benefit Transfer, Stored-Value Card, and Electronic Data Interchange Service* have been revised. The changes incorporate the current revenue limit of 49 percent (previously 30 percent) that the Board approved on November 26, 2003 (effective January 8, 2004). These services may be provided to others (outside third parties) if the total annual revenues derived from those activities involving data processing, data storage, and data transmission services (that are not financial, banking, or economic related) do not exceed the revised limit. BHCs may request permission to administer the 49 percent revenue test on a business-line or multiple-entity basis. See section 225.28(b)(14) of Regulation Y (12 CFR 225.28(b)(14)).

A more detailed summary of changes is included with the update package. The *Manual* and updates, including pricing information, are available from Publications Fulfillment, Mail Stop 127, Board of Governors of the Federal Reserve System, Washington, DC 20551 (or charge by facsimile: 202-728-5886). The *Manual* is also available on the Board's public web site at www.federalreserve.gov/boarddocs/supmanual/.

SUPPORT OF PLAN TO DEVELOP NEW CENTRAL BANKING PUBLICATION

The Federal Reserve Board on July 26, 2004, announced plans to support the development of a new publication focused on central bank theory and practice and issued a call for research papers The International Journal of Central Banking (IJCB) will be a joint project of the Bank for International Settlements (BIS), the European Central Bank, and each of the Group of Ten (G-10) central banks, with participation expected from other central banks The G-10 central banks are the Bank of Canada, the Bank of England, the Bank of France, the Bank of Italy, the Bank of Japan, the Deutsche Bundesbank, the Federal Reserve Board, the National Bank of Belgium, the Netherlands Bank, the Sveriges Riksbank, and the Swiss National Bank

The IJCB will publish refereed articles of high analytical quality for a professional audience The journal will feature policy-relevant articles on any aspect of the theory and practice of central banking, with special emphasis on research bearing on monetary and financial stability. The objectives of the IJCB are to widely disseminate the best policy-relevant and applied research on central banking and to promote communication among researchers both inside and outside of central banks Federal Reserve Board Governor Ben S Bernanke will serve as the initial managing editor, and will work with designees from the sponsoring institutions to develop the journal Governor Donald L Kohn has agreed to serve as the Board's representative to the journal's governing committee.

European Central Bank economist Dr Frank Smets and Bank of Japan policy board member Dr Kazuo Ueda will serve as IJCB co-editors The journal board will appoint additional co-editors as well as a small group of associate editors to help coordinate solicitation and review of articles

The BIS will host the journal's web site, which will be accessible to readers free of charge. Print copies will be available by subscription. The IJCB sponsors held their initial meeting in July and have a goal of publishing the first quarterly issue in early 2005

RELEASE OF MINUTES TO DISCOUNT RATE MEETINGS

The Federal Reserve Board on May 13, 2004, released the minutes of its discount rate meetings from February 9, 2004, through March 15, 2004

On July 8, 2004, the Federal Reserve Board released the minutes of its discount rate meetings from March 29, 2004, through May 3, 2004.

ANNOUNCEMENT OF MEETING OF THE CONSUMER ADVISORY COUNCIL

The Board of Governors of the Federal Reserve System on June 1, 2004, announced that the Consumer Advisory Council would hold its next meeting on Thursday, June 24, 2004. The meeting took place in Dining Room E, Terrace level, in the Board's Martin Building. The session began at 9 a m EDT and was open to the public

The Council's function is to advise the Board on the exercise of its responsibilities under various consumer financial services laws and on other matters on which the Board seeks its advice Time permitting, the Council planned to discuss the following topics

- courtesy overdraft protection
- foreign bank remittances and access to financial services by new immigrants
- economic growth and the regulatory paperwork reduction act of 1996
- proposed rules to the Community Reinvestment Act

Reports by committees and other matters initiated by the Council members were also discussed The Board invited comments from the public

BOARD SEEKS NOMINATIONS FOR APPOINTMENTS TO CONSUMER ADVISORY COUNCIL

The Federal Reserve Board announced on June 17, 2004, that it is seeking nominations for appointments to its Consumer Advisory Council Eleven new members will be appointed to serve three-year terms beginning in January 2005

The Council advises the Board on the exercise of its responsibilities under various consumer financial services laws and on other matters on which the Board seeks advice The group meets in Washington, D C., three times a year

Nominations should include a résumé and the following information about nominees

- complete name, title, address, telephone, e-mail address, and fax numbers,
- organization's name, brief description of organization, address, telephone, and fax numbers,

- past and present positions;
- knowledge, interests, or experience related to community reinvestment, consumer protection regulations, consumer credit, or other consumer financial services; and
- positions held in community and banking associations, councils, and boards.

Nominations should also include the complete name, organization name, title, address, telephone, e-mail address, and fax numbers for the nominator.

Letters of nomination with complete information, including a résumé for each nominee, were to be received by August 27, 2004, and nominations received after that date may not be considered.

Board Closed for Day of Mourning

The Board of Governors of the Federal Reserve System in Washington, D.C., announced on June 7, 2004, that it would be closed on Friday, June 11, 2004, in observance of the national day of mourning for former President Ronald Reagan.

The twelve regional Reserve Banks remained open and operating during normal business hours and provided all financial services as usual.

Enforcement Actions

The Federal Reserve Board on May 10, 2004, announced the issuance of an order of assessment of a civil money penalty in the amount of $100 million against UBS, AG, Zurich, Switzerland, a foreign bank.

UBS, without admitting to any allegations, consented to the issuance of the order in connection with U.S. dollar banknote transactions with counterparties in jurisdictions subject to sanctions under U.S. law, specifically Cuba, Libya, Iran, and Yugoslavia.

The transactions were conducted through UBS's Extended Custodial Inventory (ECI) facility in Zurich, Switzerland, which was operated pursuant to a contract with the Federal Reserve Bank of New York. The Reserve Bank determined that certain former officers and employees of UBS engaged in intentional acts aimed at concealing the transactions and terminated the contract in October 2003.

ECIs are overseas cash depots, operated by banks on behalf of the Federal Reserve, to facilitate distribution and repatriation of U.S. currency.

The Board acknowledged the cooperation of the U.S. Department of the Treasury and its Office of Foreign Assets Control in the preparation of this order. The order is being issued in coordination with a separate action being taken by the Swiss Federal Banking Commission.

The Federal Reserve Board on June 17, 2004, announced the issuance of a final decision and order of prohibition against Stephanie Edmond, a former employee of First Tennessee Bank, N.A., Memphis, Tennessee, as well as Bank of America, N.A., Charlotte, North Carolina. The order, the result of an action brought by the Office of the Comptroller of the Currency, prohibits Ms. Edmond from participating in the conduct of the affairs of any financial institution or holding company.

Cease and Desist Orders

The Federal Reserve Board on May 10, 2004, announced the issuance of a cease and desist order against CAB Holding, LLC, Wilmington, Delaware, and Paul Shi H. Huang, the sole shareholder of CAB Holding, LLC.

The order addresses the violation of certain conditions imposed in writing on CAB Holding and Mr. Huang in connection with the acquisition of The Chinese American Bank, New York, New York.

The Federal Reserve Board on May 14, 2004, announced the issuance of a consent order to cease and desist against Riggs National Corporation, Washington, D.C., a bank holding company, and Riggs International Banking Corporation, Miami, Florida, an Edge corporation.

Riggs National Corporation and Riggs International Banking Corporation, without admitting to any allegations, consented to the issuance of the order in connection with deficiencies relating to the lack of oversight, internal controls, and procedures to ensure compliance with the Bank Secrecy Act.

In separate, coordinated actions, the Office of the Comptroller of the Currency and the Financial Crimes Enforcement Network announced the issuance of a consent order and the assessment of a civil money penalty against Riggs Bank, N.A., a subsidiary of Riggs National Corporation and the parent of Riggs International Banking Corporation. The order and penalty relate to violations of the Bank Secrecy Act.

The Federal Reserve Board on May 27, 2004, announced the issuance of a consent order to cease and desist and order of assessment of civil money

penalty against Citigroup Inc., New York, New York, a bank holding company, and CitiFinancial Credit Company, Baltimore, Maryland, a nonbank subsidiary of Citigroup.

The order assesses a civil money penalty against CitiFinancial and requires CitiFinancial to pay restitution to certain subprime personal and home mortgage borrowers. The civil money penalty is $70 million, subject to a partial credit for restitution. The order also requires Citigroup and CitiFinancial to take steps to maintain and enhance compliance with consumer protection laws.

Citigroup and CitiFinancial, without admitting any allegations, consented to the issuance of the order in connection with CitiFinancial's lending activities and its conduct during an examination by the Federal Reserve Bank of New York.

Written Agreements

The Federal Reserve Board on April 30, 2004, announced the execution of a written agreement by and among Cache Valley Banking Company, Logan, Utah; the Cache Valley Bank, Logan, Utah; the Utah State Department of Financial Institutions, Salt Lake City, Utah; and the Federal Reserve Bank of San Francisco.

The Federal Reserve Board on May 14, 2004, announced the execution of a written agreement by and among Putnam-Greene Financial Corporation, Eatonton, Georgia; The Citizens Bank of Cochran, Cochran, Georgia; the Banking Commissioner of the State of Georgia, Atlanta, Georgia; and the Federal Reserve Bank of Atlanta.

The Federal Reserve Board on June 1, 2004, announced the execution of a written agreement by and between CIB Marine Bancshares, Inc., Pewaukee, Wisconsin, and the Federal Reserve Bank of Chicago.

The Federal Reserve Board on June 3, 2004, announced the execution of a written agreement by and among Utah Bancshares, Ephraim, Utah; the Bank of Ephraim, Ephraim, Utah; the Utah State Department of Financial Institutions, Salt Lake City, Utah; and the Federal Reserve Bank of San Francisco.

The Federal Reserve Board on July 2, 2004, announced the execution of a written agreement by and between Kenco Bancshares, Inc., Jayton, Texas, and the Federal Reserve Bank of Dallas.

The written agreement addresses, among other things, a violation of a written condition imposed by the Federal Reserve in connection with an application involving Kenco Bancshares, Inc.

The Federal Reserve Board on July 12, 2004, announced the execution of a written agreement by and among the First Midwest Bank, Itasca, Illinois; the Illinois Department of Financial and Professional Regulation; and the Federal Reserve Bank of Chicago.

The Federal Reserve Board, the New York State Banking Department, and the Illinois Department of Financial and Professional Regulation on July 26, 2004, announced the execution of a written agreement by and among ABN AMRO Bank, N.V., Amsterdam, The Netherlands; ABN AMRO's branch in New York, New York; the Federal Reserve Bank of Chicago; the Federal Reserve Bank of New York; the New York State Banking Department; and the Illinois Department of Financial and Professional Regulation.

The written agreement addresses Bank Secrecy Act and anti-money laundering compliance at ABN AMRO's New York branch, including policies and practices relating to the provision of correspondent banking services.

Termination of Enforcement Actions

The Federal Reserve Board on April 30, 2004, announced the termination of the enforcement actions listed below. The Federal Reserve's enforcement action web site, www.federalreserve.gov/boarddocs/enforcement, reports the terminations as they occur.

- Korea Exchange Bank, Seoul, Korea, and its affiliated branches and agency offices
  Order of consent dated May 16, 2000
  Terminated April 22, 2004
- First American Bank, Elk Grove Village, Illinois
  Written agreement dated September 26, 2003
  Terminated February 19, 2004
- First State Bank of West Manchester, West Manchester, Ohio
  Written agreement dated April 25, 2003
  Terminated February 18, 2004
- Madison Bank, Blue Bell, Pennsylvania
  Written agreement dated June 20, 2002
  Terminated February 9, 2004

- Midstate Bancorp, Inc , Hinton, Oklahoma
  Written agreement dated March 1, 2003
  Terminated December 2, 2003
- Bank of Ephraim, Ephraim, Utah
  Written agreement dated October 26, 2001
  Terminated November 11, 2003
- MSB Shares, Inc , and MidSouth Bank, Jonesboro, Arkansas
  Written agreement dated February 5, 2002
  Terminated October 23, 2003
- Texas Coastal Bank, Pasadena, Texas
  Cease and desist order dated May 16, 1995
  Terminated October 22, 2003
- O A.K. Financial Corporation and Byron Center State Bank, Byron Center, Michigan
  Written agreement dated October 4, 2002
  Terminated October 16, 2003

On June 1, 2004, the Federal Reserve Board announced the termination of the enforcement action listed below

- The Marathon Bank, Winchester, Virginia
  Written agreement dated May 20, 2003
  Terminated April 30, 2004

CHANGES IN BOARD STAFF

General Counsel Virgil Mattingly retired on June 30, 2004, after thirty years of service with the Federal Reserve Board, including twenty-five years as a member of the Board's official staff

Stephen C Schemering, Senior Adviser and former Deputy Director in the Division of Banking Supervision and Regulation, retired from the Board on June 4, 2004, after nearly thirty years of service

Steve Siciliano, Assistant General Counsel in the Legal Division, retired from the Board on June 30, 2004, after thirty-one years of service.

The Board of Governors on June 29, 2004, announced the selection of Scott G Alvarez as its general counsel, effective July 1, 2004

Mr. Alvarez succeeds Virgil Mattingly, who announced in April his intention to retire

The Board of Governors approved on July 22, 2004, the following officer promotions and appointments in the Division of Research and Statistics

- David L. Reifschneider, Assistant Director, promoted to deputy associate director
- William L Wascher III, Assistant Director, promoted to deputy associate director
- J. Nellie Liang, Assistant Director and Chief, promoted to assistant director with line responsibility for the Capital Markets and Flow of Funds Sections
- S Wayne Passmore, Assistant Director and Chief, promoted to assistant director with line responsibility for the Household and Real Estate Finance Section
- Douglas Elmendorf appointed assistant director and chief of the Macroeconomic Analysis Section
- Diana Hancock appointed assistant director and chief of the Monetary and Financial Studies Section
- Daniel Sichel appointed assistant director with line responsibility for the Fiscal Analysis Section

David L Reifschneider joined the Board in 1982 as an economist in the National Income Section. He was promoted to senior economist in 1989, and was named chief of the Macroeconomics and Quantitative Studies Section in 1996 He was promoted to the official staff as assistant director in 2000. Mr. Reifschneider received his Ph.D from the University of Wisconsin

William L Wascher III began his Board career in 1983 as an economist in the Wages, Prices, and Productivity Section. He was promoted to senior economist in 1989 Mr Wascher served as senior economist at the Council of Economic Advisers in 1989 and 1990 He has also been a visiting economist at the Bank for International Settlements In 1998, he was promoted to chief of the Wages, Prices, and Productivity Section, and in 2000, he was made chief of the Macroeconomic Analysis Section. Mr. Wascher was appointed to the official staff as assistant director in 2001 He received his Ph.D in economics from the University of Pennsylvania.

J Nellie Liang joined the Division of Research and Statistics in 1986 as an economist in the Financial Structure Section In 1994, she moved to the Capital Markets Section and was named chief of the section in 1997. She was appointed to the official staff in 2001 as assistant director and chief Ms Liang received her Ph.D in economics from the University of Maryland.

S Wayne Passmore began his career at the Federal Reserve Bank of New York in 1984 He moved briefly to the Board as a staff economist in 1987, before taking a position as assistant vice president at the Federal Home Loan Bank in San Francisco Mr. Passmore returned to the Board in 1990 as a senior economist in the Capital Markets Section He was promoted to chief of the Financial Institutions Section in 1997, a section that was the predecessor of

the current Household and Real Estate Finance Section. He was promoted to the official staff in 2000 as assistant director and chief He received his doctoral degree from the University of Michigan

Douglas Elmendorf joined the Board in 1995 as an economist in the Division of Monetary Affairs. In 1998, he took a leave of absence to serve on the staff of the Council of Economic Advisers. In 1999, he joined the Treasury Department as a deputy assistant secretary. Mr Elmendorf rejoined the Board in 2001 as a senior economist in the Macroeconomic Analysis Section in the Division of Research and Statistics Since 2002, he has served as chief of that section. He received his Ph D in economics from Harvard University in 1989

Diana Hancock joined the Board in 1991 as an economist in the Division of Monetary Affairs, and then served in the Division of Reserve Bank Operations and Payment Systems, where she was promoted to senior economist in 1996 She joined the Monetary and Financial Studies Section in the Division of Research and Statistics in 1997, and was named chief of the section in 1999 Ms Hancock received her Ph.D. in economics from the University of British Columbia.

Daniel Sichel joined the Board in 1988 as an economist in the Economic Activity Section in the Division of Research and Statistics He left the Board in 1993 to become a research associate at the Brookings Institution In 1995, Mr Sichel joined the Treasury Department as deputy assistant secretary for macroeconomic analysis. He re-joined the Board in 1996 as a senior economist in the Economic Activity Section Mr Sichel worked in the Industrial Output Section before joining the Capital Markets Section He received his Ph.D. in economics from Princeton University □

Legal Developments

ORDERS ISSUED UNDER BANK HOLDING COMPANY ACT

Orders Issued Under Section 3 of the Bank Holding Company Act

JP Morgan Chase & Co.
New York, New York

Order Approving the Merger of Financial Holding Companies

JP Morgan Chase & Co ("Morgan Chase"), a financial 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 merge with Bank One Corporation[1] and to acquire Bank One Corporation's subsidiary banks, including its lead subsidiary bank, Bank One, National Association, also in Chicago ("Bank One").[2]

JP Morgan, with total consolidated assets of approximately $771 billion, is the third largest insured depository organization in the United States,[3] controlling deposits of $197 2 billion, which represents approximately 3 8 percent of total deposits of insured depository institutions in the United States[4] JP Morgan operates insured depository institutions in California, Connecticut, Delaware, Florida, New Jersey, New York, and Texas[5] and engages nationwide in numerous nonbanking activities that are permissible under the BHC Act

Bank One Corporation, with total consolidated assets of approximately $327 billion, is the sixth largest depository organization in the United States, controlling deposits of approximately $147 4 billion, which represents approximately 2 8 percent of total deposits of insured depository institutions in the United States Bank One Corporation operates depository institutions in Arizona, Colorado, Delaware, Florida, Illinois, Indiana, Kentucky, Louisiana, Michigan, Ohio, Oklahoma, Texas, Utah, West Virginia, and Wisconsin It also engages in a broad range of permissible nonbanking activities in the United States and abroad[6]

On consummation of the proposal, JP Morgan would become the second largest insured depository organization in the United States, with total consolidated assets of approximately $1 1 trillion and total deposits of $344.6 billion, representing approximately 6 7 percent of total deposits of insured depository institutions in the United States

Factors Governing Board Review of the Transaction

The BHC Act enumerates the factors the Board must consider when reviewing the merger of bank holding companies or the acquisition of banks These factors are the competitive effects of the proposal in the relevant geographic markets, the financial and managerial resources and future prospects of the companies and banks involved in the transaction, the convenience and needs of the communities to be served, including the records of performance under the Community Reinvestment Act (12 U.S.C §2901 *et seq*) ("CRA") of the insured depository institutions involved in the transaction, and the availability of information needed to determine and enforce compliance with the BHC Act In cases involving interstate bank acquisitions, the Board also must consider the concentration of deposits nationwide and in certain individual states,

1 JP Morgan and Bank One Corporation also have requested the Board's approval to hold and exercise options to purchase up to 19 9 percent of each other's common stock Both options would expire on consummation of the proposal

2 Bank One Corporation also owns Bank One, National Association ("Bank One-Ohio") and Bank One Trust Company, both in Columbus, Ohio, Bank One, Dearborn, National Association, Dearborn, Michigan ("Bank One-Dearborn"), and Bank One, Delaware, National Association, Wilmington, Delaware

3 Asset data for JP Morgan are as of December 31, 2003, and nationwide ranking data are as of September 30, 2003, and are adjusted to reflect mergers and acquisitions completed through May 2004

4 Deposit data are as of December 31, 2003, and reflect the unadjusted total of the deposits reported by each organization's insured depository institutions in their Consolidated Reports of Condition and Income for December 31, 2003 In this context, insured depository institutions include commercial banks, savings banks, and savings associations

5 JP Morgan owns JPMorgan Chase Bank, New York, New York ("JP Morgan Bank"), Chase Manhattan Bank USA, National Association, Newark, Delaware ("Chase USA"), and JP Morgan Trust Company, N A, Los Angeles, California ("JP Morgan Trust") On January 30, 2004, the Board approved JP Morgan's acquisition of Chase FSB, Newark, Delaware, a de novo federal savings bank that JP Morgan subsequently elected not to establish

6 JP Morgan proposes to acquire Bank One Corporation's domestic and foreign nonbanking subsidiaries, all of which are engaged in permissible activities listed in section 4(k)(4)(A)–(H) of the BHC Act, pursuant to section 4(k) and the post-transaction notice procedures of section 225 87 of Regulation Y JP Morgan also proposes to acquire Bank One Corporation's Edge and Agreement corporations, which are organized under sections 25 and 25A of the Federal Reserve Act (12 USC §601 *et seq*, 12 USC §611 *et seq*)

as well as compliance with other provisions of the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 ("Riegle–Neal Act") [7]

Public Comment on the Proposal

Notice of the proposal, affording interested persons an opportunity to submit comments, has been published (69 *Federal Register* 7,748 and 17,664 (2004)), and the time for filing comments has expired. Because of the extensive public interest in the proposal, the Board held public meetings in New York and Chicago and provided an extended comment period of 81 days to allow interested persons an opportunity to present oral or written testimony on the factors that the Board must review under the BHC Act [8] More than 150 people testified at the public meetings, many of whom also submitted written comments Approximately 290 additional commenters submitted written comments

A large number of commenters supported the proposal and commended JP Morgan and Bank One Corporation for their commitment to local communities and for their leadership in community development activities These commenters praised both institutions' records of providing affordable mortgage loans, investments, grants and loans in support of economic and community revitalization projects, charitable contributions in local communities, and other community services Many of the commenters also praised JP Morgan's nationwide $800 billion, ten-year community economic development plan ("Community Development Initiative") that was announced at the public meeting in New York

Many commenters, however, expressed concern about the proposal or opposed the acquisition Most of these comments alleged general or specific deficiencies in the record of performance of JP Morgan or Bank One Corporation in helping to meet the credit needs of their communities under the CRA Several commenters believed that the merger would reduce competition for banking services, substantially increase concentration in the banking industry, and result in the loss of local control over lending and investment decisions Many commenters were generally troubled by the size of the acquisition and alleged deficiencies in the Community Development Initiative Some commenters expressing concerns had enjoyed positive experiences with either JP Morgan or Bank One Corporation and were concerned about the effect of the merger on their relationships in the future

In evaluating the statutory factors under the BHC Act, the Board carefully considered the information and views presented by all commenters, including the testimony at the public meetings and the information and views submitted in writing The Board also considered all the information presented in the applications, notices, and supplemental filings by JP Morgan and Bank One Corporation, various reports filed by the relevant companies, publicly available information, and other reports. In addition, the Board reviewed confidential supervisory information, including examination reports of the bank holding companies and the depository institutions involved and information provided by other federal banking agencies, the Securities and Exchange Commission ("SEC"), and the Department of Justice ("DOJ"). After a careful review of all the facts of record, and for the reasons discussed in this order, the Board has concluded that the statutory factors it is required to consider under the BHC Act and other relevant banking statutes are consistent with approval of the proposal.

Interstate Analysis

The Board may not approve an interstate proposal under section 3(d) of the BHC Act if the applicant controls, or upon consummation of the proposed transaction would control, more than 10 percent of the total amount of deposits of insured depository institutions in the United States On consummation of this proposal, JP Morgan would control approximately 6 7 percent of deposits nationwide Accordingly, Board approval of this proposal is not barred by the nationwide deposit limitation in section 3(d).

Section 3(d) 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 bank holding company's home state if certain conditions are met For purposes of the BHC Act, the home state of JP Morgan is New York,[9] and Bank One Corporation's subsidiary banks are located in Arizona, Colorado, Delaware, Florida, Illinois, Indiana, Kentucky, Louisiana, Michigan, Ohio, Oklahoma, Texas, Utah, West Virginia, and Wisconsin [10]

Based on a review of all the facts of record, including relevant state statutes, the Board finds that all the conditions for an interstate acquisition enumerated in section 3(d) are met in this case [11] In light of all the facts of

7 Pub L No 103-328, 108 Stat 2338 (1994)

8 The New York public meeting was held on April 15, 2004, and the Chicago public meeting was held on April 23

9 *See* 12 USC § 1842(d) A bank holding company's home state is the state in which the total deposits of all banking subsidiaries of such company were the largest on July 1, 1966, or the date on which the company became a bank holding company, whichever is later

10 For purposes of the Riegle–Neal Act, the Board considers a bank to be located in the states in which the bank is chartered or headquartered or operates a branch *See* 12 USC §§ 1841(o)(4)–(7) and 1842(d)(1)(A) and (d)(2)(B)

11 *See* 12 USC §§ 1842(d)(1)(A)–(B) and 1842(d)(2)(A)–(B) JP Morgan is adequately capitalized and adequately managed, as defined by applicable law In addition, on consummation of the proposal, JP Morgan would control less than 30 percent of, or less than the applicable state deposit cap for, the total deposits of insured depository institutions in each of Arizona, Colorado, Delaware, Florida, Illinois, Indiana, Kentucky, Louisiana, Michigan, Ohio, Oklahoma, Texas, Utah, West Virginia, and Wisconsin Two commenters contended that, on consummation of this proposal, JP Morgan's deposits in Texas would exceed the state's deposit cap The Texas Banking Commissioner has informed the Board that consummation of the proposal would comply with all the requirements of Texas law All of Bank One Corporation's subsidiary banks have been in existence for more than five years, and all other requirements under section 3(d) of the BHC Act also would be met on consummation of this proposal

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 a proposal that would result in a monopoly or would be in furtherance of any attempt to monopolize the business of banking in any relevant banking market The BHC Act also prohibits the Board from approving a proposed bank acquisition that would substantially lessen competition in any relevant banking market, unless 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 [12]

JP Morgan and Bank One Corporation compete directly in seven local banking markets in Delaware, Florida, and Texas [13] The Board has reviewed the competitive effects of the proposal in each of these banking markets in light of all the facts of record, including public comments on the proposal [14] In particular, the Board has considered the number of competitors that would remain in the markets, the relative shares of total deposits in depository institutions in the markets ("market deposits") controlled by JP Morgan and Bank One Corporation,[15] the concentration level of market deposits and the increase in this level as measured by the HHI under the DOJ Merger Guidelines, and other characteristics of the markets [16]

Consummation of the proposal would be consistent with DOJ Merger Guidelines and Board precedent in six of these banking markets After consummation, one market would remain unconcentrated and four markets would be moderately concentrated [17] The remaining market would be highly concentrated, but with only a modest increase in concentration [18] In addition, numerous competitors would remain in each of these banking markets after consummation of the proposal.[19]

Houston Banking Market

The structural effects of the proposal in the Houston, Texas, banking market ("Houston banking market"), as measured by the HHI on the basis of deposits, would substantially exceed the DOJ Guidelines According to the Summary of Deposits ("SOD") for June 30, 2003, JP Morgan operates the largest depository institution in the Houston banking market, controlling deposits of $32 7 billion, which represents approximately 41 6 percent of market deposits Bank One Corporation operates the fourth largest depository institution in the market, controlling deposits of $4 3 billion, which represents approximately 5 5 percent of market deposits After the proposed merger, JP Morgan would continue to operate the largest depository institution in the market, controlling deposits of approximately $37 billion, which represents approximately 47.1 percent of market deposits Based on market deposits, the HHI would increase by 459 points to 2421 As indicated in the DOJ Merger Guidelines and Board precedent, the Board conducts an in-depth review of the competitive effects of a merger in any highly concentrated market that experiences a significant change in the HHI for deposits. As the HHI increases or the change in the HHI resulting from a proposal becomes larger, increasingly stronger mitigating factors are required to support a determination that the competitive effects of the proposal are not significantly adverse

JP Morgan has argued that, for purposes of evaluating the competitive effects of the proposal in the Houston banking market, the Board should exclude deposits from various JP Morgan business lines that are national or international in nature ("national business line deposits") and booked at JP Morgan's largest Houston branch ("Main

12 *See* 12 U S C § 1842(c)(1)

13 These banking markets are described in appendix A

14 Some commenters alleged that approval of this proposal would adversely affect competition among credit card issuers The Board continues to believe that the appropriate product market for analyzing the competitive effects of bank mergers and acquisitions is the cluster of products and services offered by banking institutions This approach is based on Supreme Court precedent, which emphasizes that it is the cluster of products and services that, as a matter of trade reality, makes banking a distinct line of commerce *See United States v Philadelphia National Bank*, 374 U S 321, 357 (1963), accord, *United States v Connecticut National Bank*, 418 U S 656 (1974), *United States v Phillipsburg National Bank*, 399 U S 350 (1969) Even if the approach advocated by the commenters were adopted, the Board notes that the increase in the Herfindahl–Hirschman Index ("HHI") and the resulting HHI would be within Department of Justice Merger Guidelines ("DOJ Merger Guidelines"), 49 *Federal Register* 26,823 (1984) Accordingly, the Board concludes that the proposal would not result in significantly adverse competitive effects on credit card issuance, because that activity is conducted on a national or global scale, with numerous other large financial organizations providing the service

15 Market share data are as of June 30, 2003, and are based on calculations in which the 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), *National City Corporation*, 70 *Federal Reserve Bulletin* 743 (1984) Thus, the Board regularly has included thrift deposits in the market share calculation on a 50 percent weighted basis *See, e g , First Hawaiian, Inc* , 77 *Federal Reserve Bulletin* 52 (1991) Some thrifts meet the Board's criteria for increased weight in the calculation of market competition, and their deposits are weighted at 100 percent

16 Under the DOJ Merger Guidelines, a market is considered unconcentrated if the post-merger HHI is less than 1000, moderately concentrated if the post-merger HHI is between 1000 and 1800, and highly concentrated if the post-merger HHI is more than 1800 The DOJ 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 DOJ has stated that the higher than normal HHI thresholds for screening bank mergers for anticompetitive effects implicitly recognize the competitive effects of limited-purpose lenders and other nondepository financial institutions

17 The Fort Worth, Texas, banking market would remain unconcentrated and the Austin, Dallas, and San Antonio banking markets, all in Texas, and the West Palm Beach, Florida, banking market would be moderately concentrated

18 The HHI would increase by only 91 points in the highly concentrated Wilmington, Delaware, banking market

19 Market data for these banking markets are provided in appendix B

Houston Branch").[20] Approximately $21.9 billion of the deposits in the Main Houston Branch are deposits of JP Morgan's Treasury and Securities Services ("TSS"), investment banking, and mortgage escrow businesses. These deposits previously were maintained at JP Morgan Bank's main office in New York and were assigned to the Main Houston Branch over a three-year period that began in 2001 for business reasons unrelated to JP Morgan's efforts to compete in the Houston banking market. Less than 5 percent of these deposits are held in the accounts of customers whose addresses are in the Houston banking market. Furthermore, JP Morgan contends that almost half of the national business line deposits are not, as a practical matter, available to fund lending by JP Morgan in the Houston banking market. JP Morgan asserts that inclusion of these deposits in calculations of market share indices for JP Morgan in the Houston banking market would distort the measures of its competitive position.

TSS has three business units: Institutional Trust Services, Investor Services, and Treasury Services. The TSS business units provide financial services, primarily to larger corporate customers located throughout the United States, Europe, and Asia. As of June 30, 2003, the TSS Treasury Services business unit accounted for $11.2 billion of the deposits booked to the Main Houston Branch. The TSS Investor Services and Institutional Trust Services business units accounted for $7.2 billion and $605 million, respectively, of the deposits maintained at the Main Houston branch. JP Morgan's investment banking business controls $718.5 million in deposits at the Main Houston Branch, and mortgage escrow deposits total $2.2 billion at the branch.

In conducting its competitive analysis in previous cases, the Board has adjusted the market deposits held by an applicant to exclude specified types of deposits only in rare situations in which evidence supported a finding that the excluded deposits were not, as a legal matter, available for use in that market, and data were available to make comparable adjustments to the market shares for all other market participants.[21] In light of the arguments and data provided by JP Morgan, the Board has conducted a more detailed analysis of its measures for predicting the likely competitive effects of the transaction in this case. As an initial step, the Board examined several alternative measures of concentration in the Houston banking market, together with other relevant data. These alternative concentration measures for the market include HHIs based on the number of branches, the dollar amount of small business loan originations, and the dollar amount of mortgage loan originations.[22] For each of these measures, the increase in the HHI is less than 100 points and the resulting HHI is well below 1000. All changes in the alternative measures are modest and are indicative of a significantly smaller effect on competition than suggested by indices based on deposits. Accordingly, these alternative HHI calculations support the proposition that the SOD data overstate the competitive effects of the proposal in the Houston banking market.

Moreover, although JP Morgan holds $32.7 billion in deposits in the Houston banking market based on SOD data, its offices there hold only $5.2 billion in loans, by far the lowest loan-to-deposit ratio for JP Morgan in any banking market in Texas. This unusually low loan-to-deposit ratio is also consistent with the proposition that SOD deposit data significantly overstate JP Morgan's presence in the Houston banking market.

In addition, data for the Houston banking market indicate that the decision by JP Morgan to maintain national business line deposits there did not affect deposit interest rates in the banking market. An analysis of the pricing of retail banking products in the Houston banking market and other banking markets in Texas (Austin, Dallas, and San Antonio) revealed that, from January 1, 2000, through December 31, 2003, the average interest rate on deposits in the Houston Metropolitan Statistical Area ("MSA") did not deviate significantly from the average rates offered in three other Texas MSAs. In addition, the movement of these deposits to the Houston banking market has not caused a significant change in JP Morgan's pricing behavior. From January 1, 2000, through December 31, 2003, JP Morgan's interest rates on deposits did not significantly deviate from those rates offered by its competitors in the Houston MSA.

As noted above, JP Morgan states that approximately half of its national business line deposits are subject to practical restrictions that constrain the organization's ability to use the deposits to support general banking activities. Some of these deposits are maintained in volatile investment accounts. Other national business line deposits are used to fund collateral requirements related to the deposits or are regularly extended by JP Morgan Bank to depositors as overdraft loans or other forms of credit. JP Morgan also states that the deposit balances held by TSS's Treasury Services unit are sufficient to fund only part of the credit demands of the unit's customers.

There also is no evidence in the record that the national business line deposits were moved to Houston or from another branch in an attempt to manipulate the SOD data used for competitive analyses by the appropriate federal supervisory agency. Rather, JP Morgan has provided evidence to demonstrate that the national business line deposits were placed in the Main Houston Branch for business reasons unrelated to JP Morgan's efforts to compete in Houston.

---

20. JP Morgan also argues that the Board's market share calculations should include at 100 percent the deposits of Washington Mutual, Inc., Stockton, California, a large thrift that operates in the Houston banking market, and should include at 50 percent the deposits of several credit unions that also compete in this market. Based on a review of the commercial lending and other activities of Washington Mutual, Inc. in Texas, the Board has determined that the thrift's deposit weighting should remain at 50 percent. The Board also reviewed the credit unions identified by JP Morgan and determined that they do not meet the criteria for increased weighting under Board precedent.

21. *See First Security Corp.*, 86 *Federal Reserve Bulletin* 122 (2000).

22. The HHI for small business loans is based on loans to businesses originated in amounts of $1 million or less.

Based on this review, the Board concludes that the SOD data substantially overstate the effective presence of JP Morgan in the Houston banking market and thus overstate the competitive effect of this acquisition in the market.[23]

To account for this overstatement, the Board has considered the structural effects of the proposal after adjusting market deposits to exclude the portion of national business line deposits in the Main Houston Branch that are attributable to customers with mailing addresses outside the Houston banking market who also do not have a presence in the Houston banking market The total amount of national business line deposits that are unrelated to Houston is approximately $17 2 billion [24]

To account for the possibility that other market competitors might maintain similar deposits in the Houston banking market, the Board has considered several methods for approximating the amount of their national business line deposits and has excluded those deposits in analyzing the competitive effects of the proposal. After making these adjustments, the structural effects of the proposal in the Houston banking market are either within or moderately exceed the DOJ Merger Guidelines, depending on which method is used to adjust the competitors' deposits [25]

The Board also examined other aspects of the structure of the Houston banking market After consummation of the proposal, 85 depository institutions would compete in the Houston banking market, including three insured depository institutions that each would control more than 6 percent of market deposits The second and third largest competitors in the market currently rank among the five largest bank holding companies nationally by asset data as of December 31, 2003 Two of JP Morgan's bank competitors also operate similar branch networks in the market

In addition, the Houston banking market is attractive for entry by out-of-market competitors Seven de novo banks have been chartered since 1998, and five existing banking organizations have entered the market through branching since 2000 Moreover, demographic data indicate that the Houston banking market will likely remain attractive for entry The Houston MSA is the second most populous of 25 MSAs in Texas, and since 2000, its population growth has exceeded the average population growth in all other Texas MSAs

Based on a careful review of these and other facts of record, the Board concludes that the SOD data overstate the competitive effect of the proposal in the Houston banking market and that the characteristics of the market further mitigate the transaction's potential anticompetitive effects Although the analysis and data in this case are more complex than in previous cases, the Board believes that, together and under the particular circumstances of this case, they provide a more accurate picture of the likely competitive effects of the proposed transaction.

The Board also has consulted with and considered the views of the DOJ on the competitive effects of the proposal in the Houston banking market The DOJ has advised the Board that consummation likely would not have a significantly adverse effect on competition in any relevant market In addition, the Board has requested the views of the Comptroller of the Currency ("OCC") on the competitive effects of the proposal, and the OCC has not indicated that it raises competitive issues

In this light, and based on all the facts of record, the Board concludes that consummation of the proposal would not have a significantly adverse effect on competition or on the concentration of banking resources in the Houston banking market or in any relevant banking market Accordingly, competitive considerations are consistent with approval

Financial, Managerial, and Other Supervisory Factors

Section 3 of the BHC Act requires the Board to consider the financial and managerial resources and future prospects of the companies and banks involved in the proposal and certain other supervisory factors The Board has carefully considered the financial and managerial resources and future prospects of JP Morgan, Bank One Corporation, and their respective subsidiary banks in light of all the facts of record In reviewing the financial and managerial factors, the Board has considered, among other things, confidential reports of examination and other supervisory information

23 A commenter noted that JP Morgan instituted numerous changes in its SOD data immediately before submitting this proposal and maintained that the Board should prevent large banking organization from arbitrarily shifting deposits through amendments to SOD data These changes are separate from the considerations discussed above JP Morgan has provided information about the changes to support its contention that they were principally to correct errors in the SOD data as originally reported

24 Approximately $21 9 billion in deposits have been identified by JP Morgan as national business line deposits If those deposits were excluded from the calculation of the competitive effect of this proposal, JP Morgan would have a pro forma market share of 26 6 percent and the banking market's HHI would increase by 290 points to 1104 Of the $21 9 billion in deposits, approximately $20 9 billion is attributable to customers with addresses outside the Houston banking market If $20 9 billion in deposits were excluded from the calculations, JP Morgan would have a pro forma market share of 27 9 percent and the HHI would increase 306 points to 1159 Of this $20 9 billion, $3 7 billion in deposits is attributable to customers with addresses outside the Houston market, but who maintain a physical presence (*e g* , retail establishment, manufacturing plant, or business office) in the Houston banking market If the $17 2 billion in deposits associated with customers with non-Houston addresses and no physical presence in the Houston banking market were excluded from the calculation, the pro forma market share of JP Morgan would be 32 2 percent and the HHI would increase 356 points to 1375 All of these increases are within the DOJ Merger Guidelines

25 The Board considered three methods for approximating comparable deposits held by competitors in the Houston banking market The first method excluded deposits in the largest branch of every market competitor, including competitors headquartered in Texas and competitors controlled by out-of-state banking organizations This method likely overstates the amount of out-of-market deposits held by competitors in the Houston banking market and, therefore, understates the competitive strength of those institutions The second method excluded deposits in the largest branch of all out-of-state market competitors The third method excluded from each out-of-state institution's Houston deposits the same percentage of deposits that were excluded from JP Morgan's Houston deposits (53 percent) Under these methods, the HHIs increased by 577 to 1985, by 432 to 1532, and by 492 to 1748, respectively

received from the primary federal supervisors of the organizations and institutions involved in the proposal, the Federal Reserve System's confidential supervisory information, and public comments on the proposal In addition, the Board has consulted with the relevant supervisory agencies, including the OCC, the primary supervisor for two of JP Morgan's banks and all of Bank One Corporation's banks The Board also has considered publicly available financial and other information on the organizations and their subsidiaries and all information on the proposal's financial and managerial aspects submitted by JP Morgan and Bank One Corporation during the application process.

In addition, the Board has considered the public comments that relate to these factors Commenters expressed concern about the size of the combined organization and questioned whether the Board and other federal agencies have the ability to supervise the combined organization and whether the combined organization presents special risks to the federal deposit insurance funds or the financial system in general

In evaluating financial factors in expansionary proposals by banking organizations, the Board consistently has considered capital adequacy to be an especially important factor JP Morgan, Bank One Corporation, and their subsidiary banks are well capitalized and would remain so on consummation of the proposal The Board has considered that the proposed merger is structured as an exchange of shares and would not increase the debt service requirements of the combined company In addition, the Board has carefully reviewed other indicators of the financial strength and resources of the companies involved, including the earnings performance and asset quality of the subsidiary depository institutions The Board has also considered the ability of the organizations to absorb the costs of the merger and their proposed integration.

The Board has considered the managerial resources of the proposed combined organization JP Morgan, Bank One Corporation, and their subsidiary depository institutions are considered well managed overall. The Board has considered its experience and that of the other relevant banking supervisory agencies with the organizations and their records of compliance with applicable banking law [26] The Board also has reviewed carefully the examination records of JP Morgan, Bank One Corporation, and their subsidiary depository institutions, including assessments of their risk management systems and other policies

Senior management of the combined organization proposes to draw from the senior executives of JP Morgan and Bank One Corporation based on the individual management strengths of each company In this case, senior executives of the two companies have formed a transition team to plan and manage the integration into the combined organization Both companies have experience with large mergers and have indicated that they are devoting significant resources to address all aspects of the merger process

The Board and other financial supervisory agencies have extensive experience supervising JP Morgan, Bank One Corporation, and their subsidiary depository institutions, as well as other banking organizations that operate across multiple states or regions The Board already has instituted an enhanced supervisory program that will permit it to monitor and supervise the combined organization effectively on a consolidated basis This program involves, among other things, continuous holding company supervision, including both on- and off-site reviews of the combined organization's material risks on a consolidated basis and across business lines, access to and analyses of the combined organization's internal reports for monitoring and controlling risks on a consolidated basis, and frequent contact with the combined organization's senior management. It also includes reviews of the policies and procedures in place at JP Morgan for ensuring compliance with applicable banking, consumer, and other laws

Consistent with the provisions of section 5 of the BHC Act, as amended by the Gramm–Leach–Bliley Act,[27] the Board relies on the SEC and other appropriate functional regulators to provide examination and other supervisory information about functionally regulated subsidiaries in order for the Board to fulfill its responsibilities as holding company supervisor of the combined entity [28] The Board has consulted with the SEC and the other relevant agencies on JP Morgan's management and compliance efforts The Board also has taken account of publicly reported issues raised about the past practices of JP Morgan and Bank One Corporation and the efforts and successes of their management to address these matters when they were raised [29]

Based on these and all the facts of record, including a review of the comments received, the Board concludes that considerations relating to the financial and managerial resources and future prospects of JP Morgan, Bank One Corporation, and their respective subsidiaries are consistent with approval of the proposal, as are the other super-

26 Some commenters criticized the management of JP Morgan and Bank One Corporation based on the existence of private litigation alleging infringement of patent rights related to digital capturing, processing, and archiving of checks and other improprieties These are isolated private disputes that are within the jurisdiction of the courts to resolve

27 Pub L No 106-102, 113 Stat 1338 (1999)

28 For additional information about the Board's supervisory program for large, complex banking organizations, such as JP Morgan, *see Supervision of Large Complex Banking Organizations*, 87 *Federal Reserve Bulletin* 47 (2001)

29 A commenter provided press reports of litigation involving the acquisition of a small number of mortgage loans from a mortgage broker by Chase Manhattan Mortgage Corporation ("CMMC"), a subsidiary of JP Morgan Bank The commenter asserted that JP Morgan and CMMC lacked adequate policies and procedures for monitoring the acquisition of loans in the secondary market The Board previously has considered similar comments in the context of recent applications by JP Morgan Bank or JP Morgan, and hereby adopts its findings in those cases *See JPMorgan Chase Bank*, 89 *Federal Reserve Bulletin* 511 (2003) ("JP Morgan/Bank One Corporation Order") and *JP Morgan Chase & Co*, 90 *Federal Reserve Bulletin* 212 (2004) ("JP Morgan/Chase FSB Order") The commenter also raised concerns about an investigation by the Oregon Department of Justice ("Oregon DOJ") into the alleged use by borrowers of fraudulent Social Security numbers in three mortgage loans underwritten by CMMC The Board previously addressed these concerns in the JP Morgan/Chase FSB Order As the Board noted in that order, the Oregon DOJ closed its inquiry into this matter on June 10, 2003

visory factors that the Board must consider under section 3 of the BHC Act[30]

Convenience and Needs Considerations

Section 3 of the BHC Act requires the Board to consider the effects of the proposal on the convenience and needs of the communities to be served and to take into account the records of the relevant insured depository institutions under the CRA The CRA requires the federal financial supervisory agencies to encourage financial institutions to help meet the credit needs of the local communities in which they operate, consistent with their safe and sound operation, and requires the appropriate federal financial supervisory agency to take into account an institution's record of meeting the credit needs of its entire community, including low- and moderate-income ("LMI") neighborhoods, in evaluating bank expansionary proposals The Board has carefully considered the convenience and needs factor and the CRA performance records of the subsidiary depository institutions of JP Morgan and Bank One Corporation, including public comments on the effect the proposal would have on the communities to be served by the resulting organization

A Summary of Public Comments on Convenience and Needs

In response to the Board's request for public comment on the proposal, more than 440 commenters submitted their views or testified at the public meetings on the proposal Approximately 300 commenters commended JP Morgan or Bank One Corporation for the financial and technical support provided to their community development organizations or related their favorable experiences with specific programs or services offered by JP Morgan or Bank One Corporation Many of these commenters also expressed their support for the proposal

More than 140 commenters expressed concern about the lending records of JP Morgan or Bank One Corporation, recommended approval of the proposal only if subject to conditions suggested by the commenter, expressed concern about large bank mergers in general, or opposed the proposal Some of these commenters alleged that community lending and philanthropy deteriorated at JP Morgan after the merger between JP Morgan and Chase Manhattan in 2001[31] Approximately 40 commenters opposed the proposal, criticizing the consumer and small business lending of JP Morgan or Bank One Corporation[32] Commenters also criticized JP Morgan or Bank One Corporation for their activities related to subprime lending Several commenters contended that data submitted under the Home Mortgage Disclosure Act (12 USC §2801 *et seq*) ("HMDA") demonstrated that JP Morgan and Bank One Corporation engaged in disparate treatment of minority individuals in home mortgage lending in certain markets In addition, several commenters asserted that JP Morgan and Bank One Corporation are plaintiffs in an unusually large number of foreclosures in certain markets and expressed concern that these cases resulted from unscrupulous practices by both organizations[33] Some commenters criticized Bank One Corporation's involvement in tax-refund-anticipation lending and urged the Board to condition approval of the proposal on a pledge to discontinue this activity[34] In addition, several commenters expressed concerns about possible branch closures resulting from the proposed merger

B CRA Performance Evaluations

As provided in the BHC Act, the Board has evaluated the convenience and needs factor in light of the appropriate federal supervisors' examinations of the CRA performance

30 Several commenters expressed concerns about the potential loss of jobs in New York or Chicago and about the degree of diversity in senior management positions in both organizations These concerns are outside the statutory factors that the Board is authorized to consider when reviewing an application under the BHC Act *See Western Bancshares, Inc v Board of Governors*, 480 F2d 749 (10th Cir 1973)

31 Some commenters alleged that mismanagement of accounts, service interruptions, mishandled transactions, and other irregularities occurred after acquisitions by JP Morgan and Bank One Corporation The Board has reviewed these comments about individual accounts and transactions in light of the facts of record, including information provided by JP Morgan and Bank One Corporation These letters have also been forwarded to the consumer complaint function at the OCC and the Board, the primary supervisors of the subsidiary banks of JP Morgan and Bank One Corporation

32 Several commenters asserted that JP Morgan has a poor record of CRA performance in California The only banking presence that JP Morgan has in California is JP Morgan Trust, which offers private banking and trust services and is examined as a "wholesale" bank for CRA purposes JP Morgan Trust's total deposits were $106 9 million as of its most recent CRA examination and only $17 8 million of that amount was on deposit at the bank's main office in Los Angeles, which is the bank's only California branch that accepts deposits

33 The Board notes that JP Morgan and Bank One Corporation act as loan servicers or trustees for a large number of mortgages The legal capacity in which either institution is involved in a foreclosure may not be readily apparent from court records Foreclosure actions *in an institution's capacity* as a loan servicer or trustee would not indicate safety and soundness issues or a failure to meet the convenience and needs of the communities served by the institution The Board notes, however, that JP Morgan has implemented a program to assist borrowers facing foreclosure by providing counseling and refinancing On consummation of this proposal, JP Morgan would be better able to assist in mitigating borrowers' losses through local branch staff in areas currently served by Bank One Corporation

34 Bank One-Ohio offers tax-refund-anticipation loans to customers through independent tax preparers All underwriting credit decisions are made by Bank One-Ohio using credit criteria consistent with safe and sound banking practices and in compliance with applicable laws Bank One Corporation also provides financing to its customers engaged in the business of tax-refund-anticipation lending, but is not involved in the lending practices or credit decisions of these lenders The credit documents executed in connection with the financing, however, require these lenders to comply with applicable laws The Board expects all bank holding companies and their affiliates to conduct tax-refund-anticipation lending free from any abusive lending practices and in compliance with all applicable law, including fair lending laws The Federal Trade Commission ("FTC"), Department of Housing and Urban Development ("HUD"), and DOJ are responsible for enforcing compliance by nondepository institutions with laws governing the activity

records of the relevant insured depository 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 the institution's overall record of performance under the CRA by its appropriate federal supervisor [35]

JP Morgan's lead bank, JP Morgan Bank, received an "outstanding" rating at its most recent CRA performance evaluation by the Federal Reserve Bank of New York, as of September 8, 2003 JP Morgan's other subsidiary banks also received "outstanding" ratings from the OCC at their most recent CRA evaluations Chase USA, as of March 3, 2003, and JP Morgan Trust, as of November 4, 2002

Bank One Corporation's lead bank, Bank One, which accounts for approximately 75 percent of the total consolidated assets of Bank One Corporation It is the successor to Bank One, N A , Illinois, Chicago, Illinois ("Bank One-Illinois"), which received a "satisfactory" rating at its most recent CRA performance evaluation by the OCC, as of March 31, 2000 ("Bank One Evaluation") [36] All of Bank One Corporation's other subsidiary banks received either "outstanding" or "satisfactory" ratings at the most recent evaluations of their CRA performance.[37]

C CRA Performance of JP Morgan

1. JP Morgan Bank

Overview As noted above, JP Morgan Bank received an overall "outstanding" rating for performance under the CRA during the evaluation period [38] The bank also received an "outstanding" rating under the lending test Examiners concluded that JP Morgan Bank's lending activity showed excellent responsiveness to retail credit needs in its assessment areas, as measured by the number and dollar amount of HMDA-reportable and small business loans originated and purchased in each area In particular, examiners characterized lending activity in the bank's primary assessment area, which included New York City, Long Island, Northern New Jersey, and parts of Connecticut and Pennsylvania as excellent and lending activity in the Texas and upstate New York assessment areas as good

During the evaluation period, the bank and its affiliates originated or purchased more than 266,000 HMDA-reportable and small business loans totaling approximately $32 8 billion [39] Examiners also noted that overall loan volume had increased 44 percent since the bank's previous examination Although a significant part of the growth was attributable to the volume of refinancings, small business lending increased 22 percent Examiners also reported that the overall geographic distribution of HMDA-reportable and small business lending reflected good loan penetration in LMI geographies across all assessment areas reviewed

Examiners noted that JP Morgan Bank's LMI Mortgage Subsidy Program helped increase the bank's mortgage loan penetration in LMI geographies Under this program, borrowers purchasing properties in LMI geographies of the bank's assessment areas are eligible for a 2 percent subsidy, up to a maximum of $4,000, on loans of up to $200,000 More than 5,200 loans were made under this program during the examination period Examiners also concluded that various innovative and flexible lending products enhanced lending to LMI borrowers and small businesses, noting that JP Morgan Bank's Residential Lending Group ("RLG") worked with local community organizations to develop new lending products and enhance existing products designed for LMI families Many of RLG's flexible lending products provide lower down-payment requirements to first-time home buyers During the examination period, more than 12,000 such loans were originated in the bank's assessment areas

Examiners also concluded that JP Morgan Bank's performance record for community development lending was outstanding overall and in each assessment area, the bank made more than $1 3 billion in community development loans during the examination period Examiners stated that this type of lending was responsive to the credit needs identified by the bank's community contacts and that affordable housing initiatives totaled $927 million or 70 percent of its community development lending Overall, JP Morgan Bank's community development lending supported the financing of more than 11,500 units of affordable housing throughout its assessment areas

JP Morgan Bank also was rated "outstanding" for its investment performance in light of its excellent record in the bank's assessment areas Overall, JP Morgan Bank's significant portfolio of qualified investments and grants, totaling $1 1 billion, included $313 million in new investments since the previous examination These investments focused on affordable housing, economic development, community services, and revitalization and stabilization projects. Examiners concluded that the bank's investments reflected excellent responsiveness to the most significant

35 *See Interagency Questions and Answers Regarding Community Reinvestment*, 66 *Federal Register* 36,620 and 36,639 (2001) A commenter, however, suggested that JP Morgan Bank manipulates its CRA performance evaluations by significantly increasing its percentage of loans to LMI and minority individuals in the year preceding its CRA evaluation and that its performance diminishes in the years after an evaluation CRA evaluations measure performance during the applicable period and do not give undue weight or consideration to a bank's increased performance within that time period If a bank's CRA performance was uneven during the evaluation period, the Board expects that its CRA performance evaluation would reflect such an inconsistent performance

36 After the Bank One Evaluation, Bank One Corporation merged 16 of its subsidiary banks into Bank One and Bank One-Ohio ("Merged Lead Banks") Each of the banks that was merged into the Merged Lead Banks received a "satisfactory" or "outstanding" rating at its most recent CRA performance evaluation by the appropriate federal financial supervisory agency

37 The CRA performance ratings of all of Bank One Corporation's subsidiary depository institutions are provided in appendix C

38 The evaluation period was from January 1, 2001, to December 31, 2002

39 The Reserve Bank considered home purchase and refinance and small business loans by JP Morgan Bank and its affiliates, CMMC and Chase USA, for purposes of the CRA performance examination

credit and community development needs in the bank's assessment areas.[40]

JP Morgan Bank received an "outstanding" rating on the service test in light of its performance in all assessment areas In particular, examiners noted that its branches were readily accessible to all portions of the bank's assessment areas. Examiners reported that JP Morgan Bank opened and closed branches and automated teller machines ("ATMs") during the evaluation period, concluding that these changes did not adversely affect the overall accessibility of the bank's delivery network In addition, examiners noted that extended morning, evening, and weekend hours were tailored to accommodate the convenience and needs of the assessment areas, particularly LMI areas Examiners also noted that JP Morgan Bank offered multiple alternative delivery systems that enhanced the distribution of banking services, such as a network of 329 ATMs in which 28 percent were in LMI areas Many of these ATMs feature instructions in Spanish, Korean, Chinese, French, Italian, Russian, or Portuguese Examiners stated that JP Morgan Bank offered Chase Online Banking for Small Businesses, which allowed customers to view business and personal accounts together and pay employees electronically In addition, they reported that JP Morgan Bank offered Ready Pay Electronic Transfer Accounts to provide people without bank accounts an opportunity to receive direct deposits of government payments

New York JP Morgan Bank received an "outstanding" rating under the lending test in its New York assessment area [41] Examiners concluded that an analysis of the bank's lending activity, distribution of loans among borrowers of different income levels and businesses of different sizes, and community development loans demonstrated excellent performance with good geographic loan distribution Specifically, examiners noted that the overall geographic distribution of HMDA-reportable and small business loans reflected good penetration in LMI geographies. Examiners also concluded that home purchase and refinance lending by JP Morgan Bank in LMI geographies generally exceeded the performance of the aggregate lenders[42] in low-income census tracts and moderate-income census tracts In addition, examiners found that JP Morgan Bank's performance equaled or exceeded the performance of the aggregate lenders in home purchase and refinance lending to LMI borrowers

Examiners also commented favorably on JP Morgan Bank's performance in small business lending, noting that the overall distribution of small business loans across different income-level geographies was good and that performance in LMI census tracts equaled or exceeded the aggregate lenders' performance The distribution of loans to businesses of different sizes was considered excellent in light of the proportion of loans for $100,000 or less, the number of assessment area loans to businesses with gross annual revenues of $1 million or less, and JP Morgan Bank's performance relative to the aggregate lenders

JP Morgan Bank's performance under the investment test was rated "outstanding" by examiners, who cited the bank's level of qualified community development investments and grants as indicating excellent responsiveness to credit and community development needs Examiners noted that the bank's investments exhibited excellent responsiveness to the need for affordable housing (identified as a critical need in the New York assessment area), with investments of approximately $717 million in low-income-housing tax credits ("LIHTC") that benefited its assessment area for New York, New Jersey, and Connecticut

JP Morgan Bank's performance under the service test was rated "outstanding" in light of its excellent branch distribution and volume of community development services in its assessment area Of the 368 branches in the bank's assessment area, 73 or 20 percent were in LMI areas Examiners reported that 44 percent of JP Morgan Bank's branches were in or adjacent to LMI census tracts (four branches were in census tracts with no designated income level) Examiners concluded that alternative delivery systems somewhat enhanced the bank's performance in the assessment area and noted that 31 percent of its off-site ATMs in the assessment area were in LMI areas In addition, examiners noted that JP Morgan Bank had 15 mortgage offices in the assessment area, including two in LMI census tracts. They also reported that JP Morgan Bank's products and services were tailored to accommodate the convenience and needs of the assessment area, including LMI areas [43]

In addition, examiners reported that JP Morgan Bank was a leader in providing community development services in the assessment area They noted that JP Morgan Bank officers served on 240 boards of qualifying community development organizations in the assessment area and that the bank participated in more than 480 seminars that promoted financial literacy

Texas. JP Morgan Bank's rating for CRA performance in Texas was "outstanding" Examiners identified such factors as good responsiveness to assessment-area credit needs, good geographic distribution of loans in the bank's

---

40 Several commenters contended that JP Morgan should be required to donate a specified percentage of its pretax income to charities JP Morgan responded that it has a record of providing significant philanthropic donations in all the communities that it serves The Board notes that neither the CRA nor the agencies' implementing rules require that institutions make charitable donations

41 The New York assessment area consists of the consolidated metropolitan statistical area ("CMSA") (New York–Northern New Jersey–Long Island, New York–NJ–CT–PA)

42 The lending data of lenders in the aggregate ("aggregate lenders") represent the cumulative lending for all financial institutions that have reported HMDA data in a particular area

43 Some commenters recommended that JP Morgan initiate certain changes to the electronic benefits transfer ("EBT") business that it purchased from Citigroup Inc , New York, New York EBT in New York provides cash access for the Temporary Assistance for Needy Families program ("TANF") In response to these suggestions, JP Morgan indicated that it plans to use its ATM network to provide recipients of TANF benefits with access to cash free of charge JP Morgan also noted that several of the commenters' requests were matters to be addressed by the State of New York or the NYCE ATM Network

assessment areas, good distribution of loans among individuals of different income levels and businesses of different sizes, an excellent level of community development lending, an excellent level of qualified investments, and readily accessible delivery systems for banking services to geographies and individuals of different income levels to support the rating [44]

JP Morgan Bank's performance on the lending test in Texas was rated "high satisfactory," based primarily on a good performance in the Dallas–Fort Worth and Houston–Galveston–Brazoria CMSAs, and an adequate performance in the El Paso MSA. Examiners concluded that JP Morgan Bank's responsiveness to retail credit needs in the Texas assessment area was good relative to the bank's capacity and performance, noting that the bank and its mortgage affiliate originated and purchased more than 95,000 loans totaling approximately $10 7 billion during the examination period The overall geographic distribution of HMDA-reportable and small business loans reflected good penetration in LMI geographies

Examiners also concluded that JP Morgan Bank's community development lending performance was outstanding during the examination period, with loan commitments in the Texas assessment area totaling $234 million These loans financed 4,400 units of affordable housing

JP Morgan Bank's performance on the investment test in Texas was rated "outstanding" Examiners noted that JP Morgan Bank had a high level of qualified investments that exhibited excellent responsiveness to community development needs [45] At the examination, these investments totaled $161 million or 15 percent of the bank's qualified investments A majority of the qualified investments were directed to affordable housing initiatives. JP Morgan Bank's performance on the investment test varied across its assessment area Examiners reported that the bank made a significant number of investments in the Dallas–Fort Worth CMSA and fewer investments in the Houston–Galveston–Brazoria CMSA and El Paso MSA, but that all these areas benefited from the bank's affordable housing initiatives that were implemented statewide

JP Morgan bank's overall performance in the Texas assessment area was rated "outstanding," in light of its performance in the Dallas–Forth Worth and Houston–Galveston–Brazoria CMSAs and the El Paso MSA The bank's delivery systems were readily accessible to all geographies in the assessment area, including LMI areas The percentage of branches in or adjacent to LMI areas exceeded 40 percent in the three largest areas in the Texas assessment area

44 The examiners' conclusions on CRA performance in Texas were based predominantly on JP Morgan Bank's performance in the Dallas and Houston CMSAs and the El Paso MSA Together, these areas had a majority of the bank's deposits, branches, and HMDA-reportable and small business loans and the assessment area's population, LMI census tracts, owner-occupied housing units, and business establishments in Texas JP Morgan's assessment area encompassed the State of Texas

45 A qualified investment is any lawful investment, deposit, or grant that has as its primary purpose community development

2003 Performance JP Morgan Bank represented that its total home mortgage originations and purchase lending in its assessment areas in 2003, which includes a period of time after its most recent CRA performance evaluation, amounted to more than 157,000 loans totaling $32 6 billion Of these loans, 11 percent were in LMI census tracts and 17 percent were to LMI borrowers During 2003, JP Morgan Bank's small business lending originations in its assessment areas totaled more than 80,000 loans, for $4.1 billion dollars Approximately 28 percent of these loans were in LMI census tracts JP Morgan Bank also noted that in 2003, it originated more than 46,000 loans to businesses with revenues of $1 million or less, representing almost 60 percent of JP Morgan Bank's total small business loan originations

JP Morgan Bank also stated that it continued in 2003 to provide financing for affordable housing and economic development projects in LMI communities by focusing on LMI housing development and rehabilitation through construction lending, interim financing, permanent financing, and letters of credit, commercial revitalization projects in LMI communities, technical assistance to intermediaries, community development loans, and bridge lending to facilitate LIHTC investments The bank also made more than 300 loans totaling more than $1 2 billion for affordable housing and economic development projects in 2003 For example, it provided a $45 million revolving credit facility to be used as bridge financing for low-income housing investments in limited partnerships that qualify for LIHTCs JP Morgan Bank will underwrite the entire facility, syndicate a portion to one or two banks, and retain a $20 million share. The facility will invest in low-income multifamily residential housing nationwide

JP Morgan Bank also stated that it provided a five-year renewal of three lines of credit for the areas served by the Community Preservation Corporation ("CPC") in downstate New York ($31 million), upstate New York ($3 2 million), and New Jersey ($5 million). CPC has financed almost 85,000 housing units in approximately 2,000 separate projects in New York and New Jersey in the last 26 years

As of December 2003, JP Morgan Bank's qualified community development investments totaled almost $1 4 billion. Approximately $1 2 billion of these investments were in the New York Tri-State area and $207 million were in Texas New commitments in 2003 totaled $177 million, and the bank provided more than $25 7 million in grants eligible for consideration under the CRA JP Morgan Bank also had $1 2 billion in outstanding LIHTC investments in its assessment areas, of which $175 million were new investments made in 2003

2 Chase USA

Overview Chase USA also received an "outstanding" rating at its most recent CRA performance examination by

the OCC.[46] The bank primarily engages in credit card lending nationwide and does not operate any branches.[47] Examiners commended Chase USA for good lending activity in its assessment area, excellent borrower distribution of home mortgage loans, and good geographic distribution of home mortgage loans and awarded the bank "outstanding" ratings on the lending, investment, and service tests.[48] Examiners also concluded that community development lending and flexible loan programs had an overall positive impact on the lending test and that the bank exhibited excellent responsiveness to the credit and community development needs of its assessment area through high levels of qualified investments and grants.

Mortgage loans represented 87 percent of the loans originated by Chase USA in its New Castle County assessment area and loans to small businesses comprised approximately 13 percent. Approximately 62 percent of the home mortgage loans made by Chase USA in its assessment area were for home purchase, and the remaining loans were for home refinance. During the evaluation period, Chase USA's home mortgage loans originations almost doubled to approximately 2,570 loans and more than doubled in total dollar amount to $377 million. Chase USA ranked second in home purchase lending in the New Castle County assessment area and fourth in home refinance lending. Examiners reported that Chase USA's distribution of home mortgage loans was considered good in light of the demographics of the assessment area, where less than 16 percent of owner-occupied housing units were in LMI geographies.

Examiners considered the geographic distribution of Chase USA's loans to small business to be adequate. The bank's market share of loans to small businesses in the assessment area's two LMI geographies was substantially comparable with its overall market share in each geography.

In addition, examiners reported that Chase USA's community development lending adequately addressed the community development needs of the New Castle County assessment area. They noted that Chase USA and its affiliates originated 24 community development loans totaling almost $100 million in the assessment area or the broader regional area during the evaluation period. In addition, Chase USA issued six letters of credit for community development purposes totaling $30 million. For example, the Chase Community Development Corporation ("CCDC") provided a ten-month, $3 million credit facility that financed the construction of a charter school in a moderate-income geography of Wilmington, Delaware. Student from LMI families residing in LMI communities were expected to comprise most of the school's student body. CCDC also originated a $2.6 million construction loan to assist in rehabilitating a co-op building in the New Castle County assessment area into a 50-unit apartment complex for LMI senior citizens.

During the evaluation period, Chase USA and its affiliates made commitments of $23.4 million for qualified investments in the New Castle County assessment area, which increased its total outstanding commitments to $36.8 million. Examiners stated that Chase USA had taken a leadership role in several of the investments. Some investments were innovative or complex and accommodated the identified needs in the assessment area.

2003 Performance. In 2003, Chase USA's mortgage originations and purchases in its assessment area totaled more than 3,600 loans for approximately $562 million, of which 12 percent were to borrowers in LMI census tracts and 34 percent were to LMI borrowers. Chase USA originated approximately 290 loans for $3 million, of which 25.3 percent were to businesses in LMI census tracts. Chase USA increased its community development lending, making approximately $80 million in community development loans in 2003. For example, Chase USA provided a $5.6 million construction loan to finance the development of 96 units of family rental housing on a 15-acre site in Salisbury, Maryland. As of December 2003, Chase USA funded an additional $1.2 million in grants. Chase USA also made $2.7 million in new investments in LIHTCs in 2003.

D. CRA Performance of Bank One Corporation

As previously discussed, the most recent CRA performance evaluations of Bank One Corporation's subsidiary banks predate the current structure of the organization. Therefore, in addition to reviewing the relevant CRA performance evaluations, the Board also has evaluated extensive information submitted by Bank One Corporation about the CRA performance of its banks after their most recent CRA performance evaluations.

Overview. As noted above, the Merged Lead Banks all received "outstanding" or "satisfactory" ratings at their most recent CRA evaluations. Examiners determined that Bank One-Illinois demonstrated adequate responsiveness to the credit needs of its communities, including LMI borrowers and geographies. Examiners also reported that the Merged Lead Banks offered a variety of products and programs to assist in meeting the housing-related credit needs of LMI individuals and in LMI communities.

46. The performance evaluation was as of March 3, 2003, and covered the period from January 1, 1999, through December 31, 2002. At the request of Chase USA, the CRA performance examination included the activities of JP Morgan Bank, CMMC, JP Morgan Chase Community Development Corporation, Chase Community Development Corporation, and JP Morgan Mortgage Capital.

47. Chase USA focuses on nationwide retail lending and is the fifth largest credit card issuer in the country. It obtains deposits through the treasury desk of JP Morgan Bank and through private banking deposits. A majority of these deposits are from outside its New Castle County, Delaware, assessment area.

48. Commenters questioned the accuracy of the OCC's rating, noting that Chase USA closed its branch in Bellefonte, Delaware. That branch was originally opened in Bellefonte, a town with a population of less than 5,000 persons, to permit Chase USA to sell insurance products nationwide. After the Gramm–Leach–Bliley Act, Chase USA no longer required this branch. Chase USA's main office, which provided banking services primarily to employees, was closed during the performance evaluation period and relocated to Newark, Delaware.

Bank One has continued to provide home mortgage loans to consumers throughout its assessment areas, including those assessment areas previously served by its predecessor institutions Bank One Corporation has represented that, from 2000 through 2003, Bank One originated or purchased approximately $27 5 billion in home mortgage loans and that approximately 17.4 percent and 29 6 percent of these loans by number were originated in LMI geographies and to LMI borrowers, respectively Bank One Corporation also has represented that Bank One continues to participate in a variety of programs designed to assist the housing-credit needs of LMI individuals For example, Bank One participates in and funds a program to subsidize down-payment and closing costs in connection with home mortgage loans for LMI borrowers Bank One Corporation has represented that home mortgage loans totaling more than $37 million were originated in connection with Bank One's participation in this subsidy program in 2003

In general, examiners favorably commented on the small business lending records of the Merged Lead Banks For example, the Bank One Evaluation reported that Bank One-Illinois was the largest local small business lender in its Chicago assessment area In addition, examiners favorably noted the small business lending penetration of the Merged Lead Banks in LMI geographies in their Dallas, Detroit, Houston, Indianapolis, and Phoenix assessment areas

Bank One Corporation reported that, from 2000 through 2003, the Merged Lead Banks have originated more than 250,000 loans to small businesses throughout its assessment areas, of which approximately 13 9 percent were to small businesses in LMI geographies [49] Bank One Corporation also has initiated a Business Banker program through which certain Bank One employees are assigned to Bank One branches selected specifically for the convenience of small business customers Bank One employees in the Business Banker program focus exclusively on small businesses requiring loans of less than $250,000 In addition, Bank One has represented that in 2003, it originated approximately $22 million in loans through its Community Express Loan program offered in partnership with the Small Business Administration ("SBA"). Bank One also launched in the same year an SBA-guaranteed revolving line of credit for small businesses, including firms that might not have otherwise qualify for credit without the SBA's guarantee

Examiners noted the positive impact of Bank One-Illinois's community development lending on its overall lending activities and generally praised the community development lending activities of the Merged Lead Banks [50] Examiners also reported that the Merged Lead Banks offered an array of consumer and business loan products, including products with flexible underwriting criteria that assisted LMI customers who might not have qualified for credit under traditional underwriting standards Bank One has represented that it continues to provide community development loans throughout its assessment areas for projects that support affordable housing, economic development, and medical, employment, or other social services in LMI geographies

Examiners reported that the qualified investment activities of Bank One and the Merged Lead Banks were responsive to the small business and affordable housing needs of their communities Bank One has represented that it made community development investments totaling more than $859 million throughout its assessment areas since the Bank One Evaluation These investments benefited a variety of organizations and projects, including programs that provide affordable housing, social services for at-risk children, credit and technical assistance for small businesses, and financial literacy education for low-income persons

Examiners generally reported that the delivery systems of Bank One Corporation and the Merged Lead Banks for banking services were adequately accessible throughout their assessment areas Bank One has represented that, as of December 31, 2003, approximately 27 percent of its branches and 26 percent of its ATMs were in LMI geographies Moreover, Bank One has indicated that from 2000 to 2003, it has opened 21 new branches in LMI census tracts.

Chicago Examiners most recently evaluated Bank One Corporation's CRA performance record in the Chicago MSA as part of the Bank One Evaluation and the evaluations of American National Bank and Trust Company of Chicago, Chicago, Illinois ("American National") ("American National Evaluation") and Bank One, Illinois, National Association, Springfield, Illinois ("Bank One-Springfield") ("Bank One- Springfield Evaluation") [51] Examiners determined that the lending records of Bank One-Illinois, American National, and Bank One-Springfield demonstrated adequate responsiveness to the credit needs of their communities, which included LMI borrowers and geographies Moreover, examiners commended American National's lending record in the Chicago MSA and noted a good distribution of the bank's

49 A commenter criticized Bank One Corporation's management of farm properties through Bank One Farm and Ranch Management ("BOFRM"), contending that its primary orientation is towards "cash rent" programs that require substantial initial payments from farmers who lease farmland from BOFRM BOFRM manages farms for both trust and agency accounts According to the commenter, these credit arrangements generally do not benefit small independent farming enterprises and negatively affect rural economies JP Morgan stated that BOFRM rents approximately 95 percent of its farms to family farmers JP Morgan also stated that Bank One Corporation's agricultural loan products are structured flexibly to meet the needs of the individual businesses, which generally require working capital to meet cash flow needs, and funding to purchase equipment and other large assets and to purchase or improve real estate JP Morgan represented that, under Bank One's Agricultural Financing Policy, specialized agricultural lenders have the discretion to adjust the commercial lending products to the special credit needs of agricultural businesses

50 Examiners described as good or excellent the community development lending by Bank One, Arizona, National Association, Phoenix, Arizona, Bank One, Indiana, National Association, Indianapolis, Indiana, and Bank One, Texas, National Association, Dallas, Texas In addition, examiners characterized Bank One-Dearborn as a leader in making community development loans in the Detroit MSA

51 The assessment areas of Bank One and American National for their respective CRA evaluations included the entire Chicago MSA

home mortgage loans among borrowers of all income levels

Examiners commended Bank One-Illinois's home mortgage loan penetration in LMI census tracts During the evaluation period, Bank One-Illinois originated 16.4 percent of its total home mortgage loans to borrowers in LMI census tracts, which examiners noted exceeded the percentage of owner-occupied units in those areas The Bank One Evaluation also reported that Bank One-Illinois's home improvement and refinance loan penetration among LMI borrowers was good and that its total home mortgage loan distribution among borrowers of all income levels was adequate In addition, examiners determined that the overall distribution of home mortgage loans for American National and Bank One-Springfield among census tracts of various income levels, including LMI geographies, was good in the Chicago MSA Bank One indicated that in 2003, it originated approximately 22 5 percent of its total home mortgage loans in the Chicago MSA to borrowers in LMI census tracts and approximately 30 1 percent to LMI borrowers

Examiners reported that the geographic distribution of small loans to businesses by Bank One-Illinois and American National was adequate and that the distribution of such loans in moderate-income areas was good [52] During their evaluation periods, Bank One-Illinois, American National, and Bank One-Springfield provided 13.3 percent, 12 9 percent, and 9 3 percent of their small loans to businesses, respectively, to firms in LMI geographies In addition, examiners noted that all three banks provided a variety of SBA-sponsored loan products

Bank One Corporation reported that from 2000 through 2003, Bank One provided more than 47,000 loans to small businesses in the Chicago MSA In addition, Bank One Corporation represented that in 2003, approximately 13 percent of its loans to small businesses in the Chicago MSA were originated to firms in LMI census tracts.

The Bank One-Illinois, American National, and Bank One-Springfield Evaluations noted that community development lending primarily related to the development of affordable housing, which examiners identified as a significant credit need in the Chicago MSA Examiners reported that Bank One-Illinois and American National engaged in an adequate volume of community development lending activities in the Chicago MSA Community development lending by all three banks helped construct or renovate a total of 3,227 units of affordable housing during their evaluation periods

Bank One has continued to engage actively in community development lending in the Chicago MSA For example, Bank One states that it has provided more than $55 million in collateral trust notes from 2000 through 2003 to a community development financial institution that specializes in financing affordable multifamily housing

52 The Bank One-Illinois and American National CRA performance examinations reported that the volume of small loans to businesses was adequate

Examiners commented favorably on the community development investments of Bank One-Illinois in its Chicago assessment area The Bank One Evaluation also noted that the bank's investment activities demonstrated excellent responsiveness to the most significant credit needs of its Chicago assessment area In addition, examiners noted that Bank One-Illinois and American National provided an adequate level of community development investments in the Chicago MSA Bank One-Illinois, American National, and Bank One-Springfield maintained a total of approximately $132 1 million in qualified investments in their Chicago assessment areas during their evaluation periods Examiners noted that the community development investments of all three banks included complex qualified investments Bank One-Illinois, American National, and Bank One-Springfield made community development investments in a variety of programs, including projects related to the development of affordable housing and small businesses The Bank One Evaluation noted that the bank's community development investments in Chicago had facilitated the development or preservation of more than 5,550 housing units.

Bank One has continued to make qualified community development investments in the Chicago MSA, such as an $8 9 million investment in a mixed-income senior housing complex in an LMI community In addition, Bank One reported that it provided approximately $4 2 million in capital to a 107-unit multifamily housing project in Chicago by purchasing tax credits

Examiners also determined that Bank One-Illinois, American National, and Bank One-Springfield each provided an adequate level of banking services in the Chicago MSA, including LMI communities, and that the banks' delivery systems for those services were adequately accessible to all portions of their assessment areas Examiners reported that, during the evaluation period, Bank One-Illinois's record of opening and closing branches in the Chicago MSA resulted in more services in LMI areas and to LMI individuals They also noted that all three banks offered alternative delivery systems, including ATMs, 24-hour telephone banking, and Internet banking

In addition, examiners reported favorably on the community development services of Bank One-Illinois, American National, and Bank One-Springfield in their Chicago assessment areas These services included offering low-cost checking accounts for individuals with no previous banking experience and providing technical assistance to organizations that provided affordable housing and small business loans

Ohio As previously noted, Bank One-Ohio received a "satisfactory" rating at its most recent CRA evaluation ("Bank One-Ohio Evaluation") This evaluation indicated that the bank's lending record demonstrated a good responsiveness to the credit needs of its communities [53] Examin-

53 The review period was from March 1998 to March 2000 Bank One-Ohio's assessment areas for the evaluation included the Akron, Canton, Cleveland, Dayton, Hamilton–Middletown, Lima, Mansfield, Parkersburg–Marietta, and Youngstown MSAs in Ohio, the Cincinnati

ers commended the distribution of Bank One-Ohio's home mortgage lending among geographies and borrowers of different income levels throughout its assessment areas, including the Cincinnati MMA and the Cleveland MSA For example, in the Cincinnati MMA, Bank One-Ohio provided approximately 15 percent of its home mortgage loans in LMI census tracts, which exceeded the percentage of owner-occupied units in those areas Bank One Corporation has represented that from 2000 to 2003, Bank One-Ohio originated more than 77,200 home mortgage loans in its Ohio assessment areas, of which approximately 17 percent were in LMI census tracts and approximately 33 percent were to LMI borrowers

Examiners noted that the volume and geographic distribution of Bank One-Ohio's small loans to businesses was good. For example, in the Columbus MSA, Bank One-Ohio provided approximately 23 percent of its small loans to businesses to firms in LMI census tracts In addition, examiners noted that Bank One-Ohio offered a variety of SBA-sponsored loan products Bank One Corporation reported that from 2000 to 2003, Bank One-Ohio provided approximately 40,350 small loans to businesses in its Ohio assessment areas, of which almost 18 percent were originated to businesses in LMI census tracts.

The Bank One-Ohio Evaluation noted that the bank's overall community development lending was adequate, however, examiners characterized the bank as a leader in community development lending in the Cincinnati MMA. For example, Bank One-Ohio participated in the structuring and financing of a community development fund that renovated affordable housing and supported economic development projects in low-income areas in the Cincinnati MMA. Bank One Corporation represented that, since the Bank One-Ohio Evaluation, the bank has provided more than $9 6 million in community development loans to support affordable housing, economic development, and educational and vocational training in its Ohio assessment areas

Examiners reported that Bank One-Ohio adequately responded to community needs in Ohio through its community development investments In addition, examiners commended Bank One-Ohio's community development investment activities in the Cincinnati MMA and praised the bank's use of complex qualifying investments During the evaluation period, Bank One-Ohio made community development investments totaling $44.2 million throughout its assessments areas, including investments in projects that provided housing, job-training services, and adult education for LMI individuals Moreover, examiners noted that Bank One-Ohio's community development investments facilitated the development or renovation of more than 2,100 units of affordable housing Bank One Corporation states that the bank has made more than $155 million in qualified community development investments and donations since the Bank One-Ohio Evaluation

multistate metropolitan area ("MMA") in Ohio and Kentucky, and the non-MSA communities of Athens, Portsmouth, Sidney, Ashland–Wooster, Findley–Marion, and Zanesville, all in Ohio

E HMDA Data and Fair Lending Record

The Board also has carefully considered the lending records of JP Morgan and Bank One Corporation in light of comments on the HMDA data reported by their subsidiaries [54] Based on 2002 HMDA data, several commenters alleged that JP Morgan Bank, Chase Mortgage, Chase USA, and Bank One disproportionately excluded or denied African-American and Hispanic applicants for home mortgage loans in various MSAs in several states and did not adequately serve LMI geographies and individuals and small businesses.[55] These commenters asserted that JP Morgan's denial rates for minority applicants were higher than the rates for nonminority applicants and that JP Morgan's denial disparity ratios compared unfavorably with those ratios for the aggregate lenders in certain MSAs In the JP Morgan/Bank One Corporation Order and the JP Morgan/ChaseFSB Order, the Board considered substantially similar comments about JP Morgan's HMDA data for MSAs in several of these states, and the Board's HMDA analysis in those orders is incorporated by reference [56]

The 2002 data indicate that JP Morgan's denial disparity ratios[57] for African-American and Hispanic applicants for HMDA-reportable loans overall were comparable with or more favorable than those ratios for the aggregate lenders in all markets reviewed, with the exception of Florida [58] JP Morgan's percentages of total HMDA-reportable loans to African-Americans and Hispanic borrowers generally were comparable with or exceeded the total percentages for aggregate lenders in most of the areas reviewed Moreover, JP Morgan's percentage of total HMDA-reportable loans to borrowers in minority census tracts generally was

54 The Board analyzed 2001 and 2002 HMDA data for JP Morgan Bank and Bank One and reviewed HMDA-reportable loan originations in various MSAs and states The data for each state consisted of total mortgage originations in metropolitan areas included in the assessment areas of both banks

55 Several commenters criticized the lending performance of JP Morgan or Bank One in markets where they had no branches and, therefore, no obligations under the CRA

56 The Board reviewed the following MSAs in the JP Morgan/Bank One Corporation Order Benton Harbor and Detroit, both in Michigan, Boston, Massachusetts, Dallas, Texas, Memphis, Tennessee, Raleigh, North Carolina, Richmond, Virginia, San Francisco, California, St Louis, Missouri, and Washington, D C In the JP Morgan/Chase FSB Order, the Board reviewed the following MSAs: Denver, Colorado, Jackson, Mississippi, Portland, Oregon, and Seattle, Washington Commenters on this proposal cited these MSAs again The only MSAs identified by commenters that were not discussed in the two previous JP Morgan orders were Little Rock, Arkansas, Tucson, Arizona, and Milwaukee, Wisconsin HMDA data for these additional MSAs indicate that the percentage of JP Morgan's loan originations to African Americans and Hispanics equaled or exceeded those percentages for the aggregate lenders

57 The denial disparity ratio equals the denial rate of a particular racial category (*e g* , African Americans) divided by the denial rate for whites

58 JP Morgan operates in a portion of Florida through branches of JP Morgan Trust As previously noted, the bank is a wholesale institution that does not engage in retail bank activities

comparable with or exceeded the total percentage for aggregate lenders in the areas reviewed.[59]

The 2002 data indicate that Bank One's denial disparity ratios for African-American and Hispanic applicants for HMDA-reportable loans overall in the areas reviewed generally were comparable with or more favorable than those ratios for the aggregate lenders.[60] These data also indicate that Bank One's percentage of total HMDA-reportable loans to borrowers in minority census tracts generally was comparable with or exceeded the total percentage for the aggregate lenders.[61] Moreover, Bank One Corporation's percentage of total HMDA-reportable loans to African-American and Hispanic borrowers generally was comparable with or exceeded the total percentage for the aggregate lenders in the markets reviewed.

Although the HMDA data may reflect certain disparities in the rates of loan application, originations, and denials among members of different racial groups and persons with different income levels in certain local areas, the HMDA data generally do not indicate that JP Morgan and Bank One Corporation are excluding any race, income segment of the population, or geographic area on a prohibited basis. The Board nevertheless is concerned when HMDA data for an institution indicate disparities in lending and believes that all banks are obligated to ensure that their lending practices are based on criteria that ensure not only safe and sound lending, but also equal access to credit by creditworthy applicants regardless of their race or income level. The Board recognizes, however, 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. HMDA data, moreover, provide only limited information about the covered loans.[62] HMDA data, therefore, have limitations that make them an inadequate basis, absent other information, for concluding that an institution has not assisted adequately in meeting its community's credit needs or has engaged in illegal lending discrimination.

Because of the limitations of HMDA data, the Board has considered these data carefully in light of other information, including examination reports that provide an on-site evaluation of compliance by the subsidiary depository institutions of JP Morgan and Bank One Corporation with fair lending laws. Examiners noted no fair lending law issues or concerns in the CRA performance evaluations of the depository institutions controlled by JP Morgan or Bank One Corporation.

The record also indicates that JP Morgan and Bank One Corporation have taken steps to ensure compliance with fair lending laws. Both organizations have instituted corporate-wide policies and procedures to help ensure compliance with all fair lending and other consumer protection laws and regulations. These programs include file reviews for compliance with federal and state fair lending and other consumer protection rules and regulations, fair lending policies, and testing the integrity of HMDA data. JP Morgan and Bank One Corporation also conduct regular compliance and fair lending training for their employees. JP Morgan has stated that it is reviewing the compliance programs of Bank One Corporation and that, on consummation of the transaction, the combined organization will adopt the best practices of both JP Morgan and Bank One Corporation.

The Board also has considered the HMDA data in light of the programs described above and the overall performance records of the subsidiary banks of JP Morgan and Bank One Corporation under the CRA. These established efforts demonstrate that the banks are actively helping to meet the credit needs of their entire communities.

F. Subprime Lending and Abusive Lending Practices

As previously noted, a number of commenters cited concerns about the subprime mortgage lending and related activities of JP Morgan and Bank One Corporation. These commenters expressed concern that both organizations originate subprime loans and other alternative loan products and criticized the role of JP Morgan in purchasing subprime loans from other lenders, securitizing packages of subprime loans, purchasing securitized packages of subprime loans, and servicing or acting as trustee of record for subprime loan pools. Commenters generally argued that JP Morgan purchased subprime loans and securitized packages of subprime loans without performing adequate due diligence to screen for "predatory" loans. Other commenters expressed concern that JP Morgan and Bank One Corporation were financing unaffiliated lenders who provided subprime mortgage loans and alternative products such as payday loans.

JP Morgan Bank, Chase USA, and CMMC originate subprime mortgage loans. Bank One Corporation and its subsidiaries, however, do not engage in this activity.[63] CMMC services subprime mortgage loans and purchases subprime loans in the secondary market. JP Morgan

59. For purposes of this HMDA analysis, a minority census tract means a census tract with a minority population of 80 percent or more.

60. One commenter alleged disparities in Bank One's mortgage lending record in the New Orleans, Louisiana, and Phoenix, Arizona, MSAs. The OCC reviewed and rejected this allegation in connection with its approval of JP Morgan's acquisition of Bank One's corporate trust business in November 2003. The Board also notes that Bank One's HMDA-related lending in the Phoenix MSA equals or exceeds such lending by the aggregate lenders, including loans to all applicant groups that are frequently underserved.

61. Delaware was the only assessment area where Bank One's lending in minority census tracts was less favorable than the aggregate lenders. Bank One does not operate a retail branch in the state.

62. The data, for example, do not account for the possibility that an institution's outreach efforts may attract a larger proportion of marginally qualified applicants than other institutions attract and do not provide a basis for an independent assessment of whether an applicant who was denied credit was, in fact, creditworthy. Credit history problems and excessive debt levels relative to income (reasons most frequently cited for a credit denial) are not available from HMDA data.

63. Bank One does not originate subprime mortgage loans through brokers or purchase loans from correspondent lenders. It also does not originate or purchase "high cost" mortgage loans, as defined in the Home Ownership and Equity Protection Act ("HOEPA"), and originates prime mortgage loans only for sale in the secondary market.

Securities, Inc ("JPMSI"), a subsidiary of JP Morgan, securitizes subprime mortgage loans originated by CMMC, its affiliates, and third parties As an underwriter of mortgage-related asset-backed securities, JPMSI does not control the selection criteria for the loans and receivables in the loan pools that it securitizes and plays no role in the lending practices or credit review processes of the lenders involved[64] JP Morgan Bank is a warehouse lender providing temporary financing to mortgage lenders, including non-affiliated subprime mortgage lenders The bank also serves as a trustee for securities backed by mortgages or other assets, including subprime mortgage loans Bank One also participates in the securitization of mortgage loans as an underwriter of mortgage-backed securities and provides warehouse lines of credit to some mortgage lenders engaged in subprime lending In addition, JP Morgan and Bank One Corporation lend to companies that make payday or tax-anticipation-refund loans

The Board has previously noted that subprime lending is a permissible activity and can provide needed credit to consumers who have difficulty meeting conventional underwriting criteria[65] The Board continues to expect all bank holding companies and their affiliates to conduct their operations related to subprime lending free of any abusive lending practices and in compliance with all applicable law, including fair lending laws[66]

JP Morgan has a number of policies and procedures in place to ensure that its activities are conducted in compliance with applicable fair lending laws and are not abusive JP Morgan's subsidiary, CMMC, has developed lending practices that are used by all of the subsidiary's mortgage lending affiliates CMMC's mortgage-underwriting procedures assess the borrower's ability to repay the mortgage debt as well as the borrower's total debt Applications are also reviewed for loan-to-value ratios and credit bureau scores to determine if the applicant is eligible for a prime mortgage loan from a JP Morgan subsidiary Qualified applicants are offered the opportunity to have their applications processed as prime mortgage loans CMMC's lending procedures also prohibit HOEPA loans, mandatory prepayment penalties, short-term subprime loans with balloon payments, loan-to-value ratios in excess of 100 percent, and mandatory arbitration As discussed above, JP Morgan has implemented corporate-wide policies and procedures to help ensure compliance with all fair lending and other consumer protection laws In addition, CMMC's procedures require reappraisal of any real estate if questions are raised about its value This process uses software programs that review recent sales and foreclosures in the area to identify real estate that might be overvalued

JP Morgan has implemented a system of due diligence to help ensure that it does not purchase or otherwise invest in "predatory" subprime loans These practices include requiring originating lenders to meet specific criteria established by CMMC, conducting on-site due diligence of the lender and its operations before purchasing their loans, and obtaining representation and warranties in the purchase agreements that the loans are not "high cost," "predatory," or abusive under federal, state, or local laws and ordinances and that the lender uses procedures to ensure that no such loans are sold[67]

In addition, JP Morgan follows policies and procedures, including sampling loans in the pool, to help ensure that the subprime loans it purchases and securitizes are in compliance with applicable state and federal consumer protection laws The loan sampling process includes obtaining a secondary value on the mortgaged property, performing cost tests before purchase, and performing targeted reviews of purchased loans The review also seeks to identify any instances of "equity stripping" Moreover, JP Morgan conducts a due diligence review of firms selling subprime loans and the firms selected to service loans in each securitization to help prevent the purchase and securitization of loans that are not in compliance with applicable federal and state consumer protection laws.[68]

JP Morgan and Bank One Corporation consider the reputation of potential customers engaged in subprime lending that apply for warehouse lines of credit and have other protections in place to limit transactions with lenders that might originate loans with abusive terms These practices include accepting only conforming mortgages as collateral for a warehouse line of credit and obtaining representations and warranties in loan agreements that confirm the borrower's compliance with all applicable laws When providing warehouse lines of credit to lenders making tax-refund-anticipation and payday loans, JP Morgan and Bank One Corporation state that their credit evaluations of these types of lenders include, as applicable, the customer's reputation and other character-related issues, as well as any issues peculiar to the borrower's business or opera-

64 JPMSI does not underwrite HOEPA mortgages or other "high cost"mortgages as defined under state law

65 *See, e g, Bank of America Corporation*, 90 *Federal Reserve Bulletin* 217 (2004) ("Bank of America Order"), *Royal Bank of Canada*, 88 *Federal Reserve Bulletin* 385 (2002)

66 The Board notes that the OCC has responsibility for enforcing compliance with fair lending laws by national banks and that the FTC, HUD, and DOJ have primary responsibility for enforcing such compliance by nondepository institutions

67 Several commenters discussed a well-publicized series of foreclosures involving mortgages originated by JP Morgan on homes purchased in the Poconos during the last decade The Board previously has considered comments about these mortgages in the context of recent applications by JP Morgan or JP Morgan Bank and hereby adopts the findings in those cases The Board notes, moreover, that JP Morgan has implemented a plan to stabilize the community by reducing mortgage interest rates and the outstanding principal balances to reflect the current value of the properties More than 200 affected borrowers have accepted loan modification

68 One commenter also stated that Fairbanks Capital Corporation, a loan servicer used by JP Morgan and Bank One Corporation, engaged in illegal practices in servicing subprime loans The commenter's allegations were addressed in a settlement with the FTC and HUD dated November 12, 2003, by Fairbanks Capital Holding Corporation, which included its wholly owned subsidiary, Fairbanks Capital Corporation, and the founder of both entities Neither JP Morgan nor Bank One Corporation was implicated in the complaint filed jointly by the FTC and HUD The settlements resolved the complaint's allegations, enjoined the defendants from future law violations, and imposed restrictions on their business practices

tions that might affect credit risk These policies and procedures are designed to reduce the likelihood that either organization will be involved in "predatory" or abusive lending practices Moreover, neither JP Morgan nor Bank One Corporation plays any role in the lending practices or credit review processes of these lenders

G. Branch Closings

Several commenters expressed concerns that the proposed merger would result in possible branch closings and the Board has carefully considered these comments in light of all the facts of record JP Morgan has represented that any merger-related branch closings, relocations, or consolidations would be determined after the proposed merger of JP Morgan Bank and Merged Lead Banks later this year. The Board notes that there is little geographic overlap between the branches of the subsidiary banks of JP Morgan and Bank One Corporation JP Morgan also represents that no decision has been made on which organization's branch closure policy would be in effect after consummation of the proposed merger Both policies require review of a number of factors before closing or consolidating a branch, including an assessment of the branch, the demographics of the market, a profile of the community where the branch is located, and the effect of the proposed action on customers. The most recent CRA evaluations of JP Morgan Bank[69] and Bank One-Illinois[70] noted favorably the banks' records of opening and closing branches

The Board also has considered the fact that federal banking law provides a specific mechanism for addressing branch closings [71] Federal law requires an insured depository institution to provide notice to the public and to the appropriate federal supervisory agency before closing a branch In addition, the Board notes that the Board and the OCC, as the appropriate federal supervisors of JP Morgan Bank and Bank One Corporation's subsidiary banks will continue to review the banks' branch closing record in the course of conducting CRA performance evaluations

H Other Matters

Many commenters discussed JP Morgan's Community Development Initiative A number of commenters praised the Initiative as indicative of JP Morgan's commitment to the communities it serves Other commenters, however, expressed concerns about the Community Development Initiative. Some criticized it for providing insufficient funding for loans, investments, and grants or for lacking specific lending and investment commitments by locality, product, or program. Others urged the Board to require JP Morgan to enter into or renew agreements with certain community organizations

As the Board previously has explained, in order to approve a proposal to acquire an insured depository institution, an applicant must demonstrate a satisfactory record of performance under the CRA without reliance on plans or commitments for future action [72] Moreover, the Board has consistently stated that neither the CRA nor the federal banking agencies' CRA regulations require depository institutions to make pledges or enter into commitments or agreements with any organization. The Board views the enforceability of pledges, initiatives, and agreements with third parties as matters outside the scope of the CRA [73] In this case, as in past cases, the Board instead has focused on the demonstrated CRA performance record of the applicant and the programs that the applicant has in place to serve the credit needs of its CRA assessment areas at the time the Board reviews the proposal under the convenience and needs factor In reviewing future applications by JP Morgan under this factor, the Board similarly will review JP Morgan's actual CRA performance record and the programs it has in place to meet the credit needs of its communities at the time of such review

I Conclusion on Convenience and Needs Considerations

The Board recognizes that this proposal represents a significant expansion of JP Morgan and its scope of operations Accordingly, an important component of the Board's review has been its consideration of the effects of the proposal on the convenience and needs of all the communities served by JP Morgan and Bank One Corporation

In conducting its review, the Board has weighed the concerns expressed by commenters in light of all the facts of record, including the overall CRA records of the depository institutions of JP Morgan and Bank One Corporation

---

69 Examiners stated that JP Morgan Bank's record of opening and closing branches did not adversely affect the accessibility of the bank's delivery systems JP Morgan Bank sold, relocated, or consolidated 23 branches during its most recent CRA evaluation period Ten branches were consolidated into other branches of the bank, twelve branches were relocated, and one branch was sold One branch was relocated from a middle-income to a moderate-income census tract, and the remaining relocations involved census tracts with the same income levels Of the ten consolidations, only two changed from LMI census tracts to non-LMI census tracts The remaining consolidations involved census tracts with the same income levels

JP Morgan reported that in 2003, JP Morgan Bank closed one LMI branch in Austin, Texas, consolidated one non-LMI branch into a nearby non-LMI branch in Mount Kisco, New York, and relocated one branch in Brooklyn, New York, and Bridgeport and Ridgefield, both in Connecticut The relocations did not change the census-tract-income designation of the branches JP Morgan Bank also opened a non-LMI branch in Pearland, Texas

70 Bank One currently is expanding its branch network and has opened 58 branches in 2003 It recently announced plans to open 100 branches each year for the next three years

71 Section 42 of the Federal Deposit Insurance Act ((12 U S C § 1831r-1), as implemented by the Joint Policy Statement Regarding Branch Closings (64 *Federal Register* 34,844 (1999)), requires that a bank provide the public with at least 30-days notice and the appropriate federal supervisory agency with at least 90-days notice before the date of the proposed branch closing The bank also is required to provide reasons and other supporting data for the closure, consistent with the institution's written policy for branch closings

72 *See* Bank of America Order, *NationsBank*, 84 *Federal Reserve Bulletin* 858 (1998)

73 *See, e g* , Bank of America Order at 52, *Citigroup Inc* , 88 *Federal Reserve Bulletin* 485, 488 (2002)

A significant number of commenters have expressed support for the proposal based on the records of both organizations in helping to serve the banking needs and, in particular, the lending needs of their entire communities, including LMI areas Other commenters have expressed concern about specific aspects of JP Morgan's or Bank One Corporation's record of performance under the CRA in their assessment areas and have expressed reservations about whether the resulting organization would be as responsive to the banking and credit needs of its community as the two organizations are now The Board has carefully considered these concerns in the context of the overall CRA records of JP Morgan and Bank One Corporation, reports of examinations of CRA performance, and information provided by JP Morgan, including its responses to comments The Board also has considered information submitted by JP Morgan concerning its performance under the CRA since its last CRA performance evaluation

As discussed in this order, the record of this proposal demonstrates that the subsidiary depository institutions of JP Morgan and Bank One Corporation have strong records of meeting the credit needs of their communities The Board expects the resulting organization to continue to help serve the banking and credit needs of all its communities, including LMI neighborhoods Based on all the facts of record, and for the reasons discussed above, the Board concludes that considerations relating to the convenience and needs factor, including the CRA performance records of the relevant depository institutions, are consistent with approval of the proposal

Requests for Additional Public Meetings

As noted above, the Board held public meetings on the proposal in New York and Chicago A number of commenters requested that the Board hold additional public meetings or hearings, including at locations in Florida, Texas, and California The Board has carefully considered these requests in light of the BHC Act, the Board's Rules of Procedure, and the substantial record developed in this case [74] As previously discussed, more than 150 interested persons appeared and provided oral testimony at the two public meetings held by the Board Attendees included various elected officials, members of community groups, and representatives of businesses and business groups from cities and towns nationwide. In addition, the Board provided a period of more than 80 days for interested persons to submit written comments on the proposal More than 260 interested persons who did not testify at the public meetings provided written comments

In the Board's view, interested persons have had ample opportunity to submit their views on this proposal Numerous commenters, in fact, submitted substantial materials that have been considered carefully by the Board in acting on the proposal Commenters requesting additional public meetings have failed to demonstrate why their written comments do not adequately present their views, evidence, and allegations They also have not shown why the public meetings in New York and Chicago and the extended comment period did not provide an adequate opportunity for all interested persons to present their views and concerns. For these reasons, and based on all the facts of record, the Board has determined that additional public meetings or hearings are not required and are not necessary or warranted to clarify the factual record on the proposal Accordingly, the requests for additional public meetings or hearings are hereby denied [75]

Conclusion

Based on the foregoing, and in light of all the facts of record, the Board has determined that the applications should be, and hereby are, approved In reaching this conclusion, the Board has carefully considered all oral testimony and the written comments regarding the proposal in light of the factors it is required to consider under the BHC Act and other applicable statutes

Approval of the applications is specifically conditioned on compliance by JP Morgan with all the commitments made to the Board in connection with the proposal and with the conditions stated or referenced in this order. For purposes of this transaction, these commitments and conditions 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

74 Section 3(b) of the BHC Act does not require that the Board hold a public hearing on an application unless the appropriate supervisory authority for a bank to be acquired makes a timely written recommendation of denial (12 USC §1842(b) In this case, the Board has not received such a recommendation from any state or federal supervisory authority

75 A number of commenters requested that the Board delay action on the proposal or extend the comment period until JP Morgan

(i) Provides more detail about its Community Development Initiative,
(ii) Enters into a written, detailed, and publicly verifiable CRA agreement negotiated with community groups, or
(iii) Enters into new CRA agreements with local community groups

The Board believes that the record in this case does not warrant postponing its consideration of the proposal During the application process, the Board has accumulated a significant record, including reports of examination, supervisory information, public reports and information, and considerable public comment The Board believes this record is sufficient to allow it to assess the factors it is required to consider under the BHC Act The BHC Act and the Board's regulations establish time periods for consideration and action on proposals such as the current proposal Moreover, as discussed more fully above, the CRA requires the Board to consider the existing record of performance of an organization and does not require that the organization enter into contracts or agreements with others to implement its CRA programs For the reasons discussed above, the Board believes that commenters have had ample opportunity to submit their views and, in fact, they have provided substantial written submissions and oral testimony that have been considered carefully by the Board in acting on the proposal Based on a review of all the facts of record, the Board concludes that delaying consideration of the proposal, granting another extension of the comment period, or denying the proposal on the grounds discussed above, including informational insufficiency, is not warranted

The merger of JP Morgan and Bank One Corporation and the acquisition of Bank One Corporation's subsidiary banks shall not be consummated before the fifteenth calendar day after the effective date of this order, and no part of the proposal shall 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 June 14, 2004

Voting for this action Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, and Bernanke Absent and not voting Governor Kohn

ROBERT DEV FRIERSON
Deputy Secretary of the Board

Appendix A

Banking Markets in which JP Morgan and Bank One Corporation Compete Directly

Delaware Banking Market

Wilmington

New Castle County, Delaware, and Cecil County, Maryland

Florida Banking Market

West Palm Beach

The portion of Palm Beach County east of Loxahatchee and the towns of Indiantown and Hobe Sound

Texas Banking Markets

Austin

Austin MSA

Dallas

Dallas and Rockwall Counties, the southeastern portion of Denton County, including the towns of Denton and Lewisville, the southwestern portion of Collin County, including the towns of McKinney and Plano, and the towns of Arlington, Ferris, Forney, Grapevine, Midlothian, Terrell, and Waxahachie

Fort Worth

Johnson and Parker Counties, Tarrant County, excluding the towns of Grapevine and Arlington, and the southwestern portion of Denton County, including the towns of Roanoke and Justin, and the towns of Boyd, Newark, and Rhome

Houston

Houston Ranally Metropolitan Area and Montgomery County

San Antonio

San Antonio MSA and Kendall County

Appendix B

Banking Market Data

Unconcentrated Banking Market

Fort Worth, Texas

JP Morgan operates the seventh largest depository institution in the market, controlling deposits of $512 3 million, representing approximately 4 percent of market deposits Bank One Corporation operates the largest depository institution in the market, controlling deposits of $2.1 billion, representing approximately 16 1 percent of market deposits After the proposed merger, JP Morgan would operate the largest depository institution in the market, controlling deposits of approximately $2 6 billion, representing approximately 20 2 percent of market deposits The HHI would increase by 130 points to 991, and 59 depository institutions would remain in the banking market

Moderately Concentrated Banking Markets

Austin, Texas

JP Morgan operates the fourth largest depository institution in the market, controlling deposits of $933 3 million, representing approximately 7 7 percent of market deposits Bank One Corporation operates the third largest depository institution in the market, controlling deposits of $1 5 billion, representing approximately 12 2 percent of market deposits After the proposed merger, JP Morgan would operate the largest depository institution in the market, controlling deposits of approximately $2.4 billion, representing approximately 19 9 percent of market deposits The HHI would increase by 188 points to 1097, and 58 depository institutions would remain in the banking market

Dallas, Texas

JP Morgan operates the fourth largest depository institution in the market, controlling deposits of $7 4 billion, representing approximately 11 6 percent of market deposits Bank One Corporation operates the second largest depository institution in the market, controlling deposits of $8 1 billion, representing approximately 12.6 percent of market deposits After the proposed merger, JP Morgan would operate the largest depository institution in the market, controlling deposits of $15 5 billion, representing approximately 24 2 percent of market deposits. The HHI

would increase by 292 points to 1321, and 113 depository institutions would remain in the banking market

San Antonio, Texas

JP Morgan operates the ninth largest depository institution in the market, controlling deposits of $448 8 million, representing approximately 2 3 percent of market deposits Bank One Corporation operates the sixth largest depository institution in the market, controlling deposits of $569 million, representing approximately 3 percent of market deposits After the proposed merger, JP Morgan would operate the sixth largest depository institution in the market, controlling deposits of approximately $1 billion, representing approximately 5 3 percent of market deposits The HHI would increase by 14 points to 1530, and 50 depository institutions would remain in the banking market

West Palm Beach, Florida

JP Morgan operates the 31st largest depository institution in the market, controlling deposits of $65 8 million, representing less than 1 percent of market deposits Bank One Corporation operates the 27th largest depository institution in the market, controlling deposits of $94 4 million, representing less than 1 percent of market deposits After the proposed merger, JP Morgan would operate the 18th largest depository institution in the market, controlling deposits of $160 2 million, representing less than 1 percent of market deposits The HHI would increase by less than 1 point to 1325, and 55 depository institutions would remain in the banking market

Highly Concentrated Banking Market

Wilmington, Delaware

JP Morgan operates the second largest depository institution in the market, controlling deposits of $6.6 billion, representing 10 7 percent of market deposits Bank One Corporation operates the sixth largest depository institution in the market, controlling deposits of $2 6 billion, representing 4 3 percent of market deposits After the proposed merger, JP Morgan would remain the second largest depository institution in the market, controlling deposits of approximately $9 3 billion, representing approximately 14 9 percent of market deposits The HHI would increase by 91 points to 3060, and 33 depository institutions would remain in the banking market

Appendix C

CRA Performance Evaluations of Bank One Corporation's Subsidiary Depository Institutions

1. *Subsidiary Depository Institutions in Operation*[76]

Subsidiary Depository Institution	CRA Performance Rating	Date	Agency
Bank One-Dearborn	Outstanding	March 2001	OCC
Bank One-Ohio	Satisfactory	March 2000	OCC
First USA Bank N A, Wilmington, Delaware[77]	Outstanding	March 2002	OCC

76 Bank One Trust Company, National Association, Columbus, Ohio, is not examined for CRA performance because it is a special-purpose entity that is exempt from CRA requirements

77 First USA Bank N A now does business as Bank One, Delaware, National Association

2. *Entities Merged into Bank One*

Subsidiary Depository Institution	CRA Performance Rating	Date	Agency
American National	Satisfactory	December 1999	OCC
Bank One, Arizona, National Association, Phoenix, Arizona	Satisfactory	June 1999	OCC
Bank One, Colorado, National Association, Denver, Colorado	Outstanding	March 2000	OCC
Bank One, Florida, Venice, Florida	Satisfactory	September 1999	FDIC
Bank One-Illinois	Satisfactory	March 31, 2000	OCC
Bank One, Indiana, National Association, Indianapolis, Indiana	Satisfactory	June 1999	OCC
Bank One, Kentucky, National Association, Louisville, Kentucky	Satisfactory	March 2000	OCC
Bank One, Louisiana, National Association, Baton Rouge, Louisiana	Satisfactory	June 1999	OCC
Bank One, Michigan, National Association, Detroit, Michigan	Outstanding	December 2000	OCC
Bank One, Oklahoma, National Association, Oklahoma City, Oklahoma	Satisfactory	June 1999	OCC
Bank One-Springfield	Satisfactory	December 1999	OCC
Bank One, Texas, National Association, Dallas, Texas	Satisfactory	March 2000	OCC
Bank One, Utah, National Association, Salt Lake City, Utah	Outstanding	March 2000	OCC
Bank One, Wisconsin, Milwaukee, Wisconsin	Outstanding	February 2000	FDIC

3. *Entities Merged into Bank One-Ohio*

Subsidiary Depository Institution	CRA Performance Rating	Date	Agency
Bank One, West Virginia, Huntington, National Association, Huntington, West Virginia	Satisfactory	March 2000	OCC
Bank One, West Virginia, Wheeling, National Association, Wheeling, West Virginia	Satisfactory	March 2000	OCC

Manulife Financial Corporation
Toronto, Canada

John Hancock Financial Services, Inc.
Boston, Massachusetts

Order Approving Formation of Bank Holding Companies and Elections of Financial Holding Company Status

Manulife Financial Corporation ("Manulife") has requested the Board's approval under section 3 of the Bank Holding Company Act ("BHC Act")[1] to become a bank holding company and acquire all the voting shares of John Hancock Financial Services, Inc. ("John Hancock") (together, "Applicants"), and thereby indirectly acquire First Signature Bank and Trust Company, Portsmouth, New Hampshire ("First Signature"), a wholly owned direct subsidiary of John Hancock.[2] John Hancock has also requested the Board's approval to become a bank holding company and retain control of First Signature.[3] As part of the proposal, Manulife and John Hancock have filed with the Board elections to become financial holding companies pursuant to sections 4(k) and (*l*) of the BHC Act and section 225.82 of the Board's Regulation Y.[4]

Notice of the proposal, affording interested persons an opportunity to submit comments, has been published (68 *Federal Register* 70,506 (2003)). The time for filing comments has expired, and the Board has considered the proposal in light of the factors set forth in section 3 of the BHC Act.

Manulife, with total assets of $115.3 billion, is a Canadian insurance and financial services firm engaged principally in the business of underwriting life and health insurance and in reinsurance activities.[5] Manulife also engages in a variety of other financial activities in Canada, the United States, and other countries, including investment advisory and management services and securities brokerage activities. Manulife principally operates in the United States through subsidiaries that include two insurance companies, a registered investment advisor, and a registered open-end investment management company. Through these subsidiaries, Manulife offers individual life insurance, group pension, and annuity products and distributes educational savings plans and managed account products in every state in the United States. Manulife's only subsidiary bank, Manulife Bank of Canada, Waterloo, Ontario ("Manulife Bank"), has no banking operations in the United States.[6]

John Hancock, with total assets of $111.3 billion, is an insurance and financial services company engaged principally in underwriting life and long-term care insurance.[7] John Hancock also provides annuities, mutual funds, and other investment products, as well as investment advisory and management services, to retail and institutional customers in the United States and internationally. First Signature is a New Hampshire state chartered bank and John Hancock's only subsidiary depository institution. First Signature, the 8th largest depository institution in New Hampshire, controls assets of $355 million, which represents less than 2 percent of assets held by banks in the state.[8]

The combined organization would be the second largest life insurer in North America by market capitalization.

Factors Under the Bank Holding Company Act

The BHC Act sets forth the factors the Board must consider when reviewing the formation of a bank holding company or the acquisition of a bank. These factors are the competitive effects of the proposal in the relevant geographic markets; the financial and managerial resources and future prospects of the companies and banks involved in the proposal; the convenience and needs of the communities to be served, including the records of performance of the insured depository institutions involved in the transaction under the Community Reinvestment Act ("CRA")[9] and the availability of information to determine and enforce compliance with the BHC Act and other applicable federal laws.[10]

The Board has considered these factors in light of a record that includes information provided by Applicants, confidential supervisory and examination information, and publicly reported financial and other information. The Board also has contacted and considered information pro-

1. 12 U.S.C. § 1842.

2. Manulife proposes to acquire John Hancock through a merger with a newly formed direct subsidiary of Manulife. After the merger, John Hancock would be a wholly owned direct subsidiary of Manulife.

3. John Hancock holds First Signature in accordance with grandfather rights under section 4(f) of the BHC Act (12 U.S.C. § 1843(f)), which exempts from treatment as a bank holding company a company that has continually owned an institution that became a bank as a result of the enactment of the Competitive Equality Banking Act of 1987 (Pub. L. No. 100-86 (1987)). First Signature is an insured bank that currently accepts demand deposits but does not make commercial loans. On consummation of this proposal, neither John Hancock nor Manulife would be entitled to the exemption under section 4(f) of the BHC Act.

4. 12 U.S.C. §§ 1843(k) & (*l*); 12 CFR 225.82.

5. Asset data are as of December 31, 2003. Manulife was incorporated under Canada's Insurance Companies Act in 1999 to become the holding company for The Manufacturers Life Insurance Company ("Manufacturers Life"), which converted from mutual to stock organization in September 1999. Manufacturers Life is now a life insurance company with common shares and a wholly owned direct subsidiary of Manulife.

6. Manulife Bank, a wholly owned subsidiary of Manufacturers Life, was established in 1993 as the first federally regulated bank in Canada owned by an insurance company.

7. Asset data are as of December 31, 2003. John Hancock was incorporated in 1999 to become the holding company for John Hancock Mutual Life Insurance Company ("John Hancock Life"), which converted from mutual to stock organization on February 1, 2000. John Hancock Life is now a life insurance company with common shares and a wholly owned direct subsidiary of John Hancock.

8. Asset and ranking data are as of December 31, 2003.

9. 12 U.S.C. § 2901 *et seq.*

10. 12 U.S.C. § 1842(c). In cases involving interstate bank acquisitions by bank holding companies, the Board also must consider the concentration of deposits nationwide and in certain individual states, as well as compliance with the other provisions of section 3(d) of the BHC Act (12 U.S.C. § 1842(d)).

vided by Canada's Office of the Superintendent of Financial Institutions ("OSFI"), the primary home country supervisor of Manulife and Manulife Bank, and the appropriate federal and state agencies, including the relevant state insurance commissioners, the Federal Deposit Insurance Corporation ("FDIC"), and the Securities and Exchange Commission ("SEC").[11]

Competitive Considerations

Section 3 of the BHC Act prohibits the Board from approving a proposal that would result in a monopoly or be in furtherance of any combination to monopolize or attempt to monopolize the business of banking in any part of the United States. The BHC Act also prohibits the Board from approving a proposed bank acquisition that would substantially lessen competition in any relevant banking market unless the anticompetitive effects of the proposal in that banking market are clearly outweighed in the public interest by the probable effects of the proposal in meeting the convenience and needs of the community to be served.[12]

The proposal involves the acquisition of a bank by Manulife, which does not have any banking operations in any banking market in the United States. Based on all the facts of record, the Board concludes that consummation of the proposal would not have a significantly adverse effect on competition or on the concentration of banking resources in any relevant banking market, and that competitive considerations are consistent with approval.[13]

Financial and Managerial Factors

As previously noted, the BHC Act requires the Board to consider the financial and managerial resources and future prospects of the companies and banks involved in an acquisition.[14] The Board has reviewed information provided by Manulife and John Hancock, publicly reported and other financial information, and confidential examination and other supervisory information evaluating the financial and managerial strength of Manulife, John Hancock, and First Signature. In addition, the Board has consulted relevant supervisory authorities in the United States and Canada.

The Board has consistently considered capital adequacy to be an especially important aspect of the analysis of financial factors.[15] Manulife's capital levels are considered equivalent to those that would be required of a U.S. banking organization under similar circumstances. All the subsidiaries of Manulife and John Hancock that are subject to regulatory capital requirements currently exceed those minimum regulatory capital requirements. In addition, First Signature is well capitalized under relevant federal guidelines, and would remain so on consummation. Other financial factors are also consistent with approval.[16]

The Board has carefully considered the managerial resources of Manulife, John Hancock, and First Signature in light of all the facts of record, including a public comment on the proposal.[17] The Board notes that First Signature is considered well managed, and is expected to remain so after consummation. Based on all the facts of record, the Board has concluded that the financial and managerial resources and future prospects of Applicants and First Signature are consistent with approval under section 3 of the BHC Act.

Convenience and Needs Considerations

In acting on the proposal, the Board must consider the effects of the proposal on the convenience and needs of the communities to be served and take into account the records of the relevant insured depository institutions under the CRA. 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 institution's overall record of performance under the CRA by its appropriate federal supervisor.[18]

The Board has carefully considered the effects of the proposal on the convenience and needs of the communities to be served in light of all the facts of record, including the CRA performance record of First Signature, information provided by Applicants, and a public comment received on

11. The proposal is also subject to approval by the insurance commissioners of Massachusetts, Delaware, and Vermont, the states in which John Hancock's U.S. insurance company subsidiaries are domiciled, and by OSFI.

12. 12 U.S.C. § 1842(c)(1).

13. The combination of the nonbanking businesses of Manulife and John Hancock is subject to review for its potential effect on competition by several federal, state, and foreign regulators. The Applicants filed a pre-merger notification with the Federal Trade Commission and the Antitrust Division of the Department of Justice ("DOJ") under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (15 U.S.C. § 18a), and the DOJ granted early termination of the statutory waiting period on November 13, 2003.

14. 12 U.S.C. § 1842(c)(2).

15. *See Chemical Banking Corporation*, 82 *Federal Reserve Bulletin* 230 (1996).

16. A commenter expressed concern about press reports discussing a potential financial exposure of Manulife and John Hancock through John Hancock's holding of $152 million in public and private bonds issued by Parmalat Finanziaria SpA, an unaffiliated foreign company. The Board notes that the investment represented 0.1 percent of John Hancock's total assets and that John Hancock charged off most of that investment in 2003.

17. Citing various press reports, a commenter asserted that the activities of Manulife and John Hancock overseas have caused financial harm to individuals, damaged the environment, or caused other societal harm. The commenter also voiced concern about requests for information issued to Manulife by U.S. and Canadian regulators seeking information related to mutual fund activities. The commenter suggested that these issues reflect negatively on the managerial resources of Applicants. The Board notes that these contentions contain no evidence of illegality on the part of Manulife, nor do the press accounts indicate regulatory actions that would affect adversely the safety and soundness of the institutions involved in the proposal. The Board has consulted with and considered information received from the relevant supervisors and notes that, if any illegal activity is found, these agencies have ample authority to address such matters.

18. *Interagency Questions and Answers Regarding Community Reinvestment*, 66 *Federal Register* 36,620 and 36,639 (2001).

the proposal Manulife currently does not control an institution subject to evaluation under the CRA First Signature, the insured bank owned by John Hancock, received an overall rating of "satisfactory" at its most recent CRA performance examination by its primary federal supervisor, the FDIC, as of December 1, 1999 First Signature does not make commercial loans and has been designated as a wholesale institution for purposes of evaluation under the CRA [19]

At the most recent examination, examiners characterized First Signature's loan products that target low- and moderate-income individuals as "flexible and innovative" In considering First Signature's community development outreach, examiners reported that First Signature actively pursued opportunities to offer its specialized community development loan products, and that the Bank played a leadership role in many community development activities and organizations, including two affordable housing loan consortiums in New Hampshire

Based on these and all the facts of record, the Board has concluded that considerations relating to the convenience and needs of the communities to be served, including the CRA performance records of the institutions involved, are consistent with approval

Other Supervisory Considerations

The Board notes that a substantial portion of the U.S activities of Manulife and John Hancock are subject to functional regulation by state insurance commissioners or the SEC The Board will, consistent with the provisions of section 5 of the BHC Act as amended by the Gramm–Leach–Bliley Act, rely on the appropriate state insurance regulators and the SEC for examination and other supervisory information in fulfilling the Board's responsibilities as a holding company supervisor

The Board also has considered the supervision of Manulife as a diversified financial services company organized in Canada OSFI is the consolidated supervisor for Manulife and Manulife Bank and has legislative authority to supervise and set capital requirements for diversified financial services companies in Canada, including insurance holding companies OSFI conducts inspections of Manulife and its subsidiaries, including Manulife Bank, and requires Manulife to submit reports about its operations on a consolidated basis OSFI has stated that it supervises Manulife Bank in the same manner that it supervises other Canadian banks that the Board has previously determined to be subject to comprehensive consolidated supervision [20] OSFI also may review material dealings between Manulife and its subsidiaries and has authority to require Manulife to take measures necessary to ensure the safety and soundness of the Manulife organization.

In accordance with section 3 of the BHC Act, Manulife has provided adequate assurances that it will make available to the Board 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 [21] The Board has reviewed the restrictions on disclosure in jurisdictions where Manulife would have material operations and has communicated with relevant government authorities concerning access to information Manulife has committed that, to the extent not prohibited by applicable law, it will make available to the Board such information on the operations of its affiliates that the Board deems necessary to determine and enforce compliance with the BHC Act and other applicable federal law Manulife also has committed to cooperate with the Board to obtain any waivers or exemptions that may be necessary to enable its affiliates to make any such information available to the Board In light of these commitments, the Board has concluded that Manulife has provided adequate assurances of access to any appropriate information the Board may request

For these reasons, and based on all the facts of record, 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

Foreign Activities

Manulife Bank does not have operations in the United States Accordingly, Manulife is not eligible under section 211 23(c) of Regulation K for the exemptions available to a qualifying foreign banking organization ("QFBO").[22] Manulife has, therefore, requested that the Board make a specific determination of eligibility pursuant to section 211 23(e).[23] Based on all the facts of record, the Board has determined pursuant to section 211 23(e) that on consummation Manulife would be eligible for the exemptions available to a QFBO under section 211 23(c) of Regulation K and would not be eligible for the limited commercial and industrial activities exemption under section 211 23(f)(5)(iii) [24]

---

19 *See* 12 CFR 345 25(a) A commenter objecting to the proposal expressed concern that John Hancock planned to expand the activities of First Signature to those of a full-service bank without submitting a CRA plan as part of its application Although on consummation of this proposal John Hancock could expand the scope of First Signature's activities, Applicants have stated that there are no current plans to do so Moreover, the CRA requires that, in considering an acquisition proposal, the Board carefully review the existing CRA performance records of the relevant depository institutions First Signature's future activities, performance under the CRA, and continued qualification as a wholesale institution will be reviewed by the FDIC in connection with future CRA evaluations of First Signature, and the Board will consider the actual CRA performance record in any subsequent application by Applicants to acquire a depository institution

20 *See Canadian Imperial Bank of Commerce*, 85 *Federal Reserve Bulletin* 733 (1999), *Royal Bank of Canada*, 83 *Federal Reserve Bulletin* 442 (1997), *National Bank of Canada*, 82 *Federal Reserve Bulletin* 769 (1996), *Bank of Montreal*, 80 *Federal Reserve Bulletin* 925 (1994)

21 *See* 12 U S C § 1842(c)(3)(A)

22 12 CFR 211 23(c)

23 12 CFR 211 23(e)

24 12 CFR 211 23(f)(5)(iii) The Board has considered the factors specified in section 211 23(e) as they relate to Manulife's opera-

Other Issues

As noted above, Manulife and John Hancock engage primarily in a variety of insurance underwriting and sales activities, including underwriting life, health, and long-term care insurance, as well as reinsurance activities. Both companies also provide investment advisory and management services. These activities are permissible under the BHC Act for financial holding companies and, as described below, Manulife and John Hancock have elected to be financial holding companies for purposes of the BHC Act.

Manulife and John Hancock also engage in a limited number of activities that have not been approved under the BHC Act, including certain real estate investment, development, and management activities. Section 4(a)(2) of the BHC Act requires each company that becomes a bank holding company to conform its nonbanking activities and investments to the requirements of the BHC Act within two years from the date it becomes a bank holding company. The Board may extend this period for up to three years.[25] The Board's action on the proposal is subject to the condition that Applicants take all actions necessary to conform their activities and investments to the requirements of the BHC Act and the Board's regulations thereunder in a manner acceptable to the Board, including by divestiture if necessary, within two years of the date of consummation of the proposal or such extended time period that the Board, in its discretion, may grant.

Approval of Bank Holding Company Formations

Based on the foregoing, and in light of all the facts of record, the Board has determined that the applications to form bank holding companies should be, and hereby are, official.[26] In reaching its conclusion, the Board has considered all the facts of record in light of the factors it is required to consider under the BHC Act and other applicable statutes.[27]

Financial Holding Company Determination

Maulife and John Hancock have filed with the Board elections to become financial holding companies pursuant to sections 4(k) and (*l*) of the BHC Act and section 225.82 of Regulation Y. Manulife and John Hancock have certified that First Signature is well capitalized and well managed and would continue to be so on consummation, and they have provided all the information required by Regulation Y.

As discussed above, the Board has reviewed the examination ratings received by First Signature under the CRA and other relevant examinations and information.[28] Based on all the facts of record, the Board has determined that these elections to become financial holding companies will become effective on consummation of the proposal,[29] as long as First Signature continues to be well capitalized and well managed and has at least a "satisfactory" CRA rating on that date.

Conclusion

The Board's actions on this proposal are conditioned on compliance by Manulife and John Hancock with all the commitments made to the Board in connection with the proposal and with the conditions stated or referred to in this order, and receipt of all necessary regulatory approvals. For the purpose of these actions, these commitments

tions and has determined that these factors are consistent with approval.

A commenter opposing Manulife's request for eligibility for the QFBO exemptions asserted that Manulife does not meet the definition of a foreign banking organization on technical grounds. The commenter also asserted that John Hancock would inappropriately benefit from a determination that Manulife is entitled to the QFBO exemptions. As noted above, however, the Board, after consideration of the required factors, has made a specific determination of eligibility pursuant to section 211.23(e). This QFBO determination does not apply to the non-U.S. operations of a domestic organization such as John Hancock.

25. Section 4(a)(2) authorizes the Board, on request, to grant up to three one-year extensions of this conformance period, if the Board finds that the extensions "would not be detrimental to the public interest." (12 U.S.C. § 1843(a)(2).)

26. A commenter requested that the Board extend the comment period on this proposal. The Board has accumulated a significant record in this case, including reports of examination, supervisory information, public reports and information, and public comment. In the Board's view, interested persons have had ample opportunity to submit views on the proposal and, in fact, the commenter has provided written submissions that the Board has considered carefully in acting on the proposal. The commenter's request for additional time to comment does not identify extraordinary circumstances that would justify an extension of the public comment period for this case. Moreover, the BHC Act and Regulation Y require the Board to act on proposals submitted under those provisions within certain time periods (12 U.S.C. § 1842(b); 12 CFR 225.15(d)). Based on a review of all the facts of record, the Board has concluded that the record in this case is sufficient to warrant Board action at this time and that an extension of the comment period is not warranted. Accordingly, the request for an extension of the comment period is denied.

27. The commenter also requested that the Board hold a public hearing on the proposal. Section 3(b) of the BHC Act does not require the Board to hold a public hearing on an application unless the appropriate supervisory authority for any of the banks to be acquired makes a timely recommendation of denial of the application. The Board has not received such a recommendation. Under its regulations, the Board also may, in its discretion, hold a public meeting or hearing on an application to acquire a bank if a meeting or hearing is necessary or appropriate to clarify factual issues related to the application and to provide an opportunity for testimony. 12 CFR 225.16(e). The Board has considered carefully commenter's request in light of all the facts of record. As noted above, interested persons, including the commenter, have had ample opportunity to submit comments on the proposal, and the commenter has submitted written comments that the Board has considered carefully in acting on the proposal. The commenter's request fails to demonstrate why its written comments do not present its views adequately or why a meeting or hearing otherwise would be necessary or appropriate. 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 in this case. Accordingly, the request for a public hearing on the proposal is denied.

28. *See* 12 U.S.C. § 2903(c).

29. Manulife intends to acquire John Hancock's direct and indirect nonbanking subsidiaries pursuant to section 4(k) of the BHC Act (12 U.S.C. § 1843(k)) and the post-transaction notice procedures of section 225.87 of Regulation Y (12 CFR 225.87).

and conditions 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 acquisition of First Signature shall not be consummated before the fifteenth calendar day after the effective date of this order, or later than three months after the effective date of this order, unless such periods are extended for good cause by the Board or the Federal Reserve Bank of Boston, acting pursuant to delegated authority.

By order of the Board of Governors, effective April 5, 2004.

Voting for this action Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn

ROBERT DEV FRIERSON
Deputy Secretary of the Board

Mountain Home Bancshares, Inc
Mountain Home, Arkansas

Order Approving the Acquisition of a Bank Holding Company

Mountain Home Bancshares, Inc ("Mountain Home"), 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 USC §1842) to acquire Pocahontas Bankstock, Inc ("Pocahontas") and its subsidiary bank, Bank of Pocahontas ("BOP"), both in Pocahontas, Arkansas [1]

Notice of the proposal, affording interested persons an opportunity to submit comments, has been published (69 *Federal Register* 20,623 (2004)). 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

Mountain Home is the 33rd largest depository organization in Arkansas, with total consolidated assets of $268 4 million It controls First National Bank and Trust Company of Mountain Home ("First National"), Mountain Home, Arkansas, with deposits of $205 1 million, which represents less than 1 percent of total deposits of insured depository institutions in Arkansas ("state deposits") [2] Pocahontas, with total consolidated assets of $129 7 million, is the 73rd largest depository organization in Arkansas, controlling deposits of $108 million On consummation of the proposal, Mountain Home would become the 22nd largest depository organization in Arkansas, with total consolidated assets of approximately $398 million and deposits of approximately $313 2 million, which represents less than 1 percent of state deposits

1 After consummation of the proposal, Mountain Home would operate BOP as a subsidiary bank for a period of time

2 Asset data are as of December 31, 2003, and statewide deposit and ranking data are as of June 30, 2003

Competitive Considerations

Section 3 of the BHC Act prohibits the Board from approving a proposal that would result in a monopoly or would be in furtherance of any attempt to monopolize the business of banking in any relevant banking market. The BHC Act also prohibits the Board from approving a proposed bank acquisition that would substantially lessen competition in any relevant banking market, unless the Board finds that the anticompetitive effects of the proposal clearly are outweighed in the public interest by the probable effect of the proposal in meeting the convenience and needs of the community to be served [3]

Mountain Home and Pocahontas do not compete directly in any relevant banking market Based on all the facts of record, the Board has concluded that consummation of the proposal would have no adverse effect on competition or on the concentration of banking resources in any relevant banking market Accordingly, the Board has determined that competitive factors are consistent with approval of the proposal

Financial, Managerial, and Supervisory Considerations

Section 3 of the BHC Act requires the Board to consider the financial and managerial resources and future prospects of the companies and banks involved in the proposal and certain other supervisory factors The Board has carefully considered these factors in light of all the facts of record, including reports of examination, other confidential supervisory information received from the primary federal banking agencies that supervise the institutions, information provided by Mountain Home, and public comment on the proposal

Mountain Home is well capitalized and will remain so on consummation of the proposal In addition, the Board has consulted with the Office of the Comptroller of the Currency ("OCC"), the primary federal supervisor of First National, about the proposal The Board also has considered the managerial resources of Mountain Home and Pocahontas, including the management officials proposed for Pocahontas, and the examination records of those organizations and BOP, including their risk management systems and other policies

A commenter opposing the proposal asserted that Pocahontas and BOP did not comply with a Cease and Desist Order issued to Pocahontas by the Federal Deposit Insurance Corporation ("FDIC") regarding shareholder reporting requirements The Cease and Desist Order was terminated by the FDIC on August 28, 2003 [4] The Board has

3 12 USC §1842(c)(1)

4 The commenter also contended that Pocahontas and BOP violated provisions of state law on minority shareholder rights and shareholder meeting requirements In addition, the commenter alleged that he has not been provided with sufficient financial information about the proposed transaction to be able to determine the value of his stock ownership as a result of the proposal Mountain Home stated that in accordance with its bylaws and with Arkansas law, Pocahontas will send advance notice of a special meeting to its shareholders that

considered the information provided by Mountain Home and Pocahontas in response to the comment and has reviewed confidential supervisory information about these matters

Based on all the facts of record, the Board has concluded that considerations relating to the financial and managerial resources and future prospects of Mountain Home, Pocahontas, and BOP are consistent with approval, as are the other supervisory factors under the BHC Act

Convenience and Needs Considerations

In acting on a proposal under section 3 of the BHC Act, the Board is required to consider the effects of the proposal on the convenience and needs of the communities to be served and to take into account the records of the relevant insured depository institution under the Community Reinvestment Act ("CRA")[5] The CRA requires the federal financial supervisory agencies to encourage financial institutions to help meet the credit needs of the local communities in which they operate, consistent with their safe and sound operation, and requires the appropriate federal financial supervisory agency to take into account an institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, in evaluating bank expansionary proposals

The Board has considered carefully the convenience and needs factor and the CRA performance records of the subsidiary banks of Mountain Home and Pocahontas in light of all the facts of record Considerations relating to the convenience and needs of the community, including the performance records of First National and BOP, are consistent with approval[6]

Conclusion

Based on the foregoing and all the facts of record, the Board has determined that the application should be, and hereby is, approved In reaching its conclusion, the Board has considered all the facts of record in light of the factors that it is required to consider under the BHC Act and other applicable statutes The Board's approval is specifically conditioned on compliance by Mountain Home with the conditions imposed in this order and the commitments made to the Board in connection with the application For purposes of these actions, the commitments and conditions 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 acquisition of Pocahontas may not be consummated before the fifteenth calendar day after the effective date of this order, or 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 St Louis, acting pursuant to delegated authority

By order of the Board of Governors, effective June 7, 2004

Voting for this action Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn

ROBERT DEV FRIERSON
Deputy Secretary of the Board

will include all the information necessary to vote on the proposal The Board has consulted with the Arkansas State Banking Commission in light of the commenter's concerns Moreover, courts have concluded that the Board's limited jurisdiction to review applications under the BHC Act does not authorize it to consider matters relating to shareholder relations and appropriate shareholder compensation *See Western Bancshares, Inc v Board of Governors*, 480 F2d 749 (10th Cir 1973) These matters are governed by state corporate law and may be adjudicated by a court with jurisdiction to provide commenter with relief, if appropriate

5 12 USC §2901 *et seq*

6 At its most recent CRA evaluation by the OCC, First National received an overall "outstanding" rating, as of November 4, 2002 BOP received an overall "satisfactory" rating at its most recent CRA performance evaluation by the FDIC, as of November 1, 2002

Sky Financial Group, Inc
Bowling Green, Ohio

Order Approving the Acquisition of a Financial Holding Company and the Merger of Banks

Sky Financial Group, Inc ("Sky Financial"), a financial 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 USC §1842), to acquire Second Bancorp, Incorporated ("Second Bancorp") and its subsidiary bank, The Second National Bank of Warren ("Second Bank"), both in Warren, Ohio Sky Financial's subsidiary state member bank, Sky Bank, Salineville, Ohio, has requested the Board's approval under section 18(c) of the Federal Deposit Insurance Act (12 USC §1828(c)) (the "Bank Merger Act") to merge with Second Bank, with Sky Bank as the surviving bank In addition, Sky Bank has requested the Board's approval under section 9 of the Federal Reserve Act ("FRA") (12 USC §321) to establish branches at the locations of Second Bank's branches[1]

Notice of the proposal, affording interested persons an opportunity to submit comments, has been published in accordance with the BHC Act, the Bank Merger Act, and the Board's Rules of Procedure (12 CFR §262 3(b)) in the *Federal Register* (69 *Federal Register* 17,416 (2004)) and locally As required by the Bank Merger Act, reports of the competitive effects of the merger were requested from the United States Attorney General and the appropriate banking agencies 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 the BHC Act, the Bank Merger Act, and the FRA

Sky Financial, with total consolidated assets of approximately $12 9 billion, operates branches in Ohio, Pennsyl-

1 These branches are listed in appendix A

vania, Michigan, Indiana, and West Virginia Sky Financial controls the tenth largest insured depository institution in Ohio, controlling deposits of approximately $6 1 billion, which represents approximately 2 9 percent of total deposits in insured depository institutions in the state ("state deposits")[2] Second Bancorp, with total consolidated assets of approximately $2 1 billion, controls the 15th largest insured depository institution in Ohio, controlling approximately $1 2 billion in deposits, which represents less than 1 percent of state deposits On consummation of the proposal, Sky Financial would control the ninth largest insured depository institution in Ohio, controlling deposits of approximately $7 3 billion, which represents 3 4 percent of state deposits

Competitive Considerations

Section 3 of the BHC Act and the Bank Merger Act prohibit the Board from approving a proposal that would result in a monopoly or would be in furtherance of any attempt to monopolize the business of banking in any relevant banking market The BHC Act and the Bank Merger Act also prohibit the Board from approving a proposed bank acquisition that would substantially lessen competition in any relevant banking market, unless the Board finds that the anticompetitive effects of the proposal clearly are outweighed in the public interest by the probable effect of the proposal in meeting the convenience and needs of the community to be served[3]

Sky Financial and Second Bancorp compete directly in the Akron, Ashtabula, Canton, Cleveland, and Youngstown–Warren banking markets in Ohio[4] The Board has reviewed carefully the competitive effects of the proposal in each of these banking markets in light of all the facts of record In particular, the Board has considered the number of competitors that would remain in the markets, the share of total deposits in depository institutions in the markets ("market deposits") controlled by Sky Financial and Second Bancorp,[5] the concentration level of market deposits and the increase in this level as measured by the Herfindahl–Hirschman Index ("HHI") under the Department of Justice Merger Guidelines ("DOJ Guidelines"),[6] and other characteristics of the markets

Several factors indicate that the likely effect of consummation of this proposal on competition in these markets would not be significantly adverse[7] Consummation of the proposal would be consistent with Board precedent and the DOJ Guidelines in the Akron, Canton, and Youngstown–Warren banking markets These banking markets would remain moderately concentrated, and the increase in concentration in the Akron and Canton markets is small The Cleveland market would remain highly concentrated on consummation, but the HHI would increase by only one point In addition, more than ten competitors would remain in each of these markets

The Ashtabula market would exceed DOJ Guidelines after consummation Sky Financial would become the largest depository institution in the market and the HHI would increase by 289 points to 1,917 Although the Ashtabula market would become highly concentrated, numerous competitors would remain in the market Of the nine remaining firms in the Ashtabula market, three firms, in addition to Sky Financial, would each control 18 percent or more of market deposits The Ashtabula market also is attractive to entry, as demonstrated by the de novo entry of a bank there within the past year

The Department of Justice has conducted a detailed review of the competitive effects of the proposal and has advised the Board that consummation of the proposal would not have a significantly adverse effect on competition in the Akron, Ashtabula, Canton, Cleveland, or Youngstown–Warren banking markets or any other relevant banking market The appropriate banking agencies have been afforded an opportunity to comment and have not objected to the proposal

Based on all the facts of record, the Board concludes that consummation of the proposal is not likely to have a significantly adverse effect on competition or on the concentration of banking resources in any relevant banking market and that competitive considerations are consistent with approval

Financial, Managerial, and Other Considerations

Section 3 of the BHC Act and the Bank Merger Act require the Board to consider the financial and managerial resources and future prospects of the companies and banks involved in the proposal. The Board has considered carefully these factors in light of all the facts of record, including reports of examination, other confidential supervisory information received from the primary federal banking

2 Asset data are as of December 31, 2003, and deposit data are as of June 30, 2003 In this context, the term "insured depository institution" includes insured commercial banks, savings associations, and savings banks

3 12 USC § 1842(c)(1)

4 These banking markets are described in Appendix B

5 Market share data are as of June 30, 2003, and are based on calculations in which the 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), *National City Corporation*, 70 Federal Reserve Board 743 (1984) Thus, the Board regularly has included thrift deposits in the market share calculation on a 50 percent weighted basis *See, e g*, *First Hawaiian, Inc*, 77 *Federal Reserve Bulletin* 52 (1991)

6 Under the DOJ Guidelines, 49 *Federal Register* 26,823 (1984), a market is considered moderately concentrated if the post-merger HHI is between 1000 and 1800 and is considered highly concentrated if the post-merger HHI is more than 1800 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 Department of Justice has stated that the higher than normal HHI thresholds for screening bank mergers for anticompetitive effects implicitly recognize the competitive effects of limited-purpose lenders and other nondepository financial institutions

7 The effects of the proposal on the concentration of banking resources in these markets are described in appendix C

agency that supervises each institution, and information provided by Sky Financial Based on all the facts of record, the Board has concluded that considerations relating to the financial and managerial resources and future prospects of Sky Financial and Second Bancorp are consistent with approval, as are the other supervisory factors required to be considered under the BHC Act In addition, considerations related to the convenience and needs of the communities to be served, including the records of performance of the relevant insured depository institutions under the Community Reinvestment Act ("CRA"), are consistent with approval.

As noted above, Sky Bank also has applied under section 9 of the FRA to establish branches at the locations of Second Bank's branches in Ohio The Board has considered the factors it is required to consider under section 9 of the FRA and, for the reasons discussed in this order, finds those factors to be consistent with approval

Conclusion

Based on the foregoing and in light of all the facts of record, the Board has determined that the applications should be, and hereby are, approved In reaching this conclusion, the Board has considered all the facts of record in light of the factors that it is required to consider under the BHC Act, the Bank Merger Act, the FRA, and other applicable statutes The Board's approval is specifically conditioned on compliance by Sky Financial with all the representations and commitments made to the Board in connection with the applications and the receipt of all other required regulatory approvals These representations, commitments, and conditions 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 transaction shall not be consummated before the fifteenth calendar day after the effective date of this order or 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 Cleveland, acting pursuant to delegated authority

By order of the Board of Governors, effective May 24, 2004

8 12 USC §2901 *et seq* The Interagency Questions and Answers Regarding Community Reinvestment provides that an institution's most recent CRA performance evaluation is an important consideration in the applications process because it represents a detailed on-site evaluation of the institution's overall record of performance under the CRA by its appropriate federal supervisor 66 *Federal Register* 36,620 and 36,639 (2001) Sky Bank received a "satisfactory" rating at its most recent CRA performance evaluation by the Federal Reserve Bank of Cleveland, as of October 14, 2003 Second Bank received a "satisfactory" rating at its most recent CRA performance evaluation by the Office of the Comptroller of the Currency, as of June 26, 2000 Sky Trust, National Association, Pepper Pike, Ohio, is a special-purpose bank that is not subject to the CRA

Voting for this action Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn

ROBERT DEV FRIERSON
Deputy Secretary of the Board

Appendix A

Branches in Ohio to be Established by Sky Bank

Akron
76 South Main Street, Suite 100

Ashtabula
4366 Main Avenue

Aurora
215 West Garfield Road

Beachwood
25201 Chagrin Boulevard, Suite 120

Canfield
6515 Tippecanoe Road

Canton
5310 Fulton Road, NW

Conneaut
328 Main Street

Cortland
259 South High Street

Fairlawn
3737 West Market Street

Garrettsville
8045 State Street

Girard
29 East Liberty Street

Hubbard
24 West Liberty Street

Hudson
5801 Darrow Road,
3477 Massillon Road

Jefferson
36 West Jefferson Street

Kent
1590 South Water Street

Lordstown
6749 Tod Avenue, SW

Medina
1065 North Court Street

Newton Falls
215 East Broad Street

Niles
5555 Youngstown-Warren Road

North Olmstead
26642 Brookpark Road Extension

Poland
2 South Main Street

Ravenna
165 North Chestnut Street

Rock Creek
3273 Main Street

Streetsboro
1190 State Route 303

Twinsburg
10071 Darrow Road

Warren
2107 Elm Road, NE
4349 Mahoning Avenue, NW
108 Main Avenue, SW
525 Niles-Cortland Road, SE
2595 Parkman Road, NW

Wooster
445 West Milltown Road

Appendix B

Ohio Banking Market Definitions

Akron

The southern two-thirds of Summit and Portage Counties, the Medina County townships of Sharon, Homer, Harrisville, Westfield, Guilford, and Wadsworth, Smith township in Mahoning County, Lawrence township and the western half of Lake township in Stark County, and Milton and Chippewa townships in Wayne County

Ashtabula

Ashtabula County

Canton

Stark County, excluding Lawrence township and the western half of Lake township, Carroll County, Smith township in Mahoning County, and Lawrence and Sandy townships in Tuscarawas County

Cleveland

Cuyahoga, Lake, Lorain, and Geauga Counties, Sagamore Hills, Northfield Center, Twinsburg, Richfield, Boston, and Hudson townships in Summit County, Medina County, excluding Homer, Harrisville, Westfield, Guilford, Wadsworth, and Sharon townships, Aurora and Streetsboro townships in Portage County, and the City of Vermillion in Erie County

Youngstown–Warren

Mahoning County, excluding Smith township; Trumbull County, excluding Brookfield and Hartford townships, and Columbiana Village and Fairfield township in Columbiana County

Appendix C

Ohio Banking Markets in which Sky Financial and Second Bancorp Compete Directly

Akron

Sky Financial operates the 19th largest insured depository institution in the Akron banking market, controlling approximately $42 million in deposits, representing less than 1 percent of market deposits Second Bancorp operates the 12th largest insured depository institution in the market, controlling $134 million in deposits, representing 1 7 percent of market deposits On consummation of the proposal, Sky Financial would operate the tenth largest insured depository institution in the market, controlling deposits of approximately $176 million, representing approximately 2 3 percent of market deposits The HHI would increase 2 points to 1,390 Twenty-four competitors would remain in the market

Astabula

Sky Financial operates the fourth largest insured depository institution in the Ashtabula banking market, controlling $118 5 million in deposits, representing 12 2 percent of market deposits Second Bancorp operates the fifth largest insured depository institution in the market, controlling $115 7 million in deposits, representing 11 9 percent of market deposits On consummation of the proposal, Sky Financial would operate the largest insured depository institution in the market, controlling deposits of approximately $234.2 million, representing approximately 24 2 percent of market deposits The HHI would increase 289 points to 1,917 Eight competitors would remain in the market

Canton

Sky Financial operates the sixth largest insured depository institution in the Canton banking market, controlling $368.9 million in deposits, representing 7 7 percent of market deposits. Second Bancorp operates the 17th largest insured depository institution in the market, controlling $13 8 million in deposits, representing less than 1 percent of market deposits On consummation of the proposal, Sky Financial would remain the sixth largest insured depository institution in the market, controlling deposits of approximately $382 7 million, representing approximately 8 per-

cent of market deposits The HHI would increase 4 points to 1,434 Sixteen competitors would remain in the market.

Cleveland

Sky Financial operates the tenth largest insured depository institution in the Cleveland banking market, controlling approximately $1 1 billion in deposits, representing 1 8 percent of market deposits Second Bancorp operates the 17th largest insured depository institution in the market, controlling approximately $185 million in deposits, representing less than 1 percent of market deposits On consummation of the proposal, Sky Financial would remain the tenth largest insured depository institution in the market, controlling deposits of approximately $1 2 billion, representing approximately 2 1 percent of market deposits The HHI would increase 1 point to 1,926 Thirty-seven competitors would remain in the market

Youngstown–Warren

Sky Financial operates the largest insured depository institution in the Youngstown–Warren banking market, controlling $773 9 million in deposits, representing 14 5 percent of market deposits Second Bancorp operates the fourth largest insured depository institution in the market, controlling $702 7 million in deposits, representing 13 2 percent of market deposits On consummation of the proposal, Sky Financial would operate the largest insured depository institution in the market, controlling deposits of approximately $1 6 billion, representing approximately 27 7 percent of market deposits The HHI would increase 383 points to 1,491 Eleven competitors would remain in the market

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

National City Corporation
Cleveland, Ohio

Order Approving the Acquisition of a Bank Holding Company

National City Corporation ("National City"), a financial 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 Provident Financial Group, Inc ("Provident") and its subsidiary bank, The Provident Bank ("Provident Bank"), both in Cincinnati, Ohio National City also has requested the Board's approval under sections 4(c)(8) and 4(j) of the BHC Act (12 U.S.C §§ 1843(c)(8) and 1843(j)) and section 225 28(b)(6) of the Board's Regulation Y (12 CFR 225 28(b)(6)) to acquire a nonbanking subsidiary of Provident and thereby engage in permissible investment advisory activities

Notice of the proposal, affording interested persons an opportunity to submit comments, has been published (69 *Federal Register* 8,660 (2004)) 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

National City, with total consolidated assets of $116 4 billion, is the 11th largest depository organization in the United States, controlling deposits of $75 2 billion, which represents approximately 1 3 percent of total deposits in insured depository institutions in the United States [1] National City is the third largest insured depository organization in Ohio, controlling deposits of $23 7 billion, which represents approximately 11 2 percent of total deposits in insured depository institutions in the state ("state deposits") National City also operates subsidiary insured depository institutions in Illinois, Indiana, Kentucky, Michigan, Missouri, and Pennsylvania

Provident, with total consolidated assets of approximately $17 1 billion, is the seventh largest insured depository organization in Ohio, controlling deposits of $10 3 billion, which represents approximately 4 9 percent of state deposits Provident Bank operates branches in Ohio and Kentucky

On consummation of this proposal, National City would become the tenth largest insured depository organization in the United States, with total consolidated assets of $133.5 billion, and would control approximately 1 4 percent of total deposits in insured depository institutions in the United States [2] National City would become the largest insured depository organization in Ohio, controlling deposits of approximately $34 billion, which represents approximately 16 1 percent of state deposits

Interstate Analysis

Section 3(d) of the BHC Act 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 [3] For purposes of the BHC Act, the home state of National City is Ohio, and Provident is located in Kentucky and Ohio [4] Based on a review of all the facts of record, including relevant state statutes, the Board finds that all the conditions for an interstate acquisition enumer-

1 Asset, nationwide deposit, and ranking data are as of December 31, 2003, and statewide deposit and ranking data are as of June 30, 2003

2 All data include National City after consummation of the proposal to acquire Allegiant Bancorp, Inc , St Louis, Missouri ("Allegiant") The Allegiant proposal was approved by the Board on March 15, 2004 *See National City Corporation*, 90 *Federal Reserve Bulletin* 236 (2004) ("*National City/Allegiant Order*")

3 A bank holding company's home state is that state in which the total deposits of all banking subsidiaries of such company were the largest on the later of July 1, 1966, or the date on which the company became a bank holding company 12 U S C § 1841(o)(4)(C)

4 For purposes of section 3(d) of the BHC Act, the Board considers a bank to be located in the states in which the bank is chartered, headquartered, or operates a branch

ated in section 3(d) are met in this case [5] In light 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 a proposal that would result in a monopoly or would be in furtherance of any attempt to monopolize the business of banking in any relevant banking market The BHC Act also prohibits the Board from approving a proposed bank acquisition that would substantially lessen competition in any relevant banking market, unless the Board finds that the anticompetitive effects of the proposal clearly are outweighed in the public interest by the probable effect of the proposal in meeting the convenience and needs of the community to be served [6]

National City and Provident compete directly in the Cleveland, Columbus, Dayton, and Springfield banking markets, all in Ohio [7] The Board has reviewed carefully the competitive effects of the proposal in each of these banking markets in light of all the facts of record In particular, the Board has considered the number of competitors that would remain in the markets, the relative shares of total deposits in depository institutions in the markets ("market deposits") controlled by National City and Provident,[8] the concentration level of market deposits and the increase in this level as measured by the Herfindahl–Hirschman Index ("HHI") under the Department of Justice Merger Guidelines ("DOJ Guidelines"),[9] and other characteristics of the markets

Consummation of the proposal would be consistent with Board precedent and the DOJ Guidelines in each of these banking markets [10] After consummation of the proposal, the Dayton banking market would remain moderately concentrated, as measured by the HHI, and numerous competitors would remain in the market Although the Cleveland, Columbus, and Springfield banking markets would remain highly concentrated, the change in market shares would be small and numerous competitors would remain in the markets

The Department of Justice also has conducted a detailed review of the competitive effects of the proposal and has advised the Board that consummation of the proposal would not have a significantly adverse effect on competition in the Cleveland, Columbus, Dayton, or Springfield banking markets or in any other relevant banking market

Based on all the facts of record, the Board concludes that consummation of the proposal would not have a significantly adverse effect on competition or on the concentration of banking resources in any relevant banking market and that competitive considerations are consistent with approval

Financial, Managerial, and Supervisory Considerations

Section 3 of the BHC Act requires the Board to consider the financial and managerial resources and future prospects of the companies and banks involved in the proposal and certain other supervisory factors The Board has carefully considered these factors in light of all the facts of record, including reports of examination, other confidential supervisory information received from the primary federal banking agency that supervises each institution, information provided by National City, and public comment on the proposal

National City is well capitalized and will remain so on consummation of the proposal [11] In addition, the Board has consulted with the Office of the Comptroller of the Currency ("OCC"), the primary federal supervisor of National City's lead banks, about the proposal [12] The Board also has considered the managerial resources and the examination records of National City and Provident and the subsidiary depository institution to be acquired, including its risk management systems and other policies [13] Based on all the

---

5 *See* 12 U S C §§ 1842(d)(1)(A) and (B), 1842(d)(2)(A) and (B) National City is adequately capitalized and adequately managed, as defined by applicable law In addition, on consummation of the proposal, National City would control less than 10 percent of the total amount of deposits of insured depository institutions in the United States and less than 15 percent of the total deposits of insured depository institutions in Kentucky, the only applicable state limitation on the amount of deposits a bank holding company can acquire in this transaction *See* Ky *Rev Stat Ann* § 287 900 (Supp 2003)

6 12 U S C § 1842(c)(1)

7 These banking markets are described in appendix A

8 Market share data are as of June 30, 2003, and are based on calculations in which the 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), *National City Corporation*, 70 *Federal Reserve Bulletin* 743 (1984) Thus, the Board regularly has included thrift deposits in the market share calculation on a 50 percent weighted basis *See, e g , First Hawaiian, Inc* , 77 *Federal Reserve Bulletin* 52 (1991)

9 Under the DOJ Guidelines, 49 *Federal Register* 26,823 (1984), a market is considered moderately concentrated if the post-merger HHI is between 1000 and 1800 and highly concentrated if the post-merger HHI is more than 1800 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 Department of Justice has stated that the higher than normal HHI thresholds for screening bank mergers for anticompetitive effects implicitly recognize the competitive effects of limited-purpose lenders and other nondepository financial institutions

10 The effects of the proposal on the concentration of banking resources in these markets are described in appendix B

11 A commenter alleged that the compensation under severance agreements for Provident's senior management is excessive The Board notes that the severance agreements have been disclosed to shareholders and that National City will remain well capitalized on consummation of the proposal

12 A commenter also expressed concern that Provident restated its earnings for the years 1997 through 2002 The Board monitored the restatement by Provident and has consulted with the Securities and Exchange Commission regarding this matter

13 One commenter criticized National City for lobbying against state and local efforts to enact and enforce anti-predatory lending laws and ordinances Two commenters expressed concern that the proposal might result in a loss of jobs The Board notes that the commenters do not allege and have provided no evidence that National City engaged in any illegal activity or other action that has affected, or may

facts of record, the Board has concluded that considerations relating to the financial and managerial resources and future prospects of National City, Provident, and Provident Bank are consistent with approval, as are the other supervisory factors under the BHC Act.

Convenience and Needs Considerations

In acting on a proposal under section 3 of the BHC Act, the Board is required to consider the effects of the proposal on the convenience and needs of the communities to be served and to take into account the records of the relevant insured depository institutions under the Community Reinvestment Act ("CRA")[14] The CRA requires the federal financial supervisory agencies to encourage financial institutions to help meet the credit needs of local communities in which they operate, consistent with their safe and sound operation, and requires the appropriate federal financial supervisory agency to take into account an institution's record of meeting the credit needs of its entire community, including low- and moderate-income ("LMI") neighborhoods, in evaluating bank expansionary proposals

The Board has considered carefully the convenience and needs factor and the CRA performance records of the subsidiary banks of National City and Provident in light of all the facts of record, including public comment on the proposal The Board recently considered the convenience and needs factor in National City's proposal to acquire Allegiant In that proposal, the Board conducted a detailed review of the CRA performance records of the insured depository institutions controlled by National City, the lending records of all the National City bank and nonbank lending subsidiaries, including an analysis of data reported by National City under the Home Mortgage Disclosure Act ("HMDA"),[15] and the branch closing policies of National City and found the record of the Allegiant proposal to be consistent with approval

A Summary of Public Comments on Convenience and Needs Considerations

In response to the Board's request for public comment on this proposal, approximately 56 commenters submitted their views Of these commenters, approximately 51 commenters supported the proposal by generally commending National City or Provident for providing financial and technical support to their community development organizations or businesses Other commenters related their favorable experiences with specific programs or services offered by National City or Provident

Five commenters opposed the proposal These commenters expressed concern about the subprime lending activities of First Franklin Financial Corporation, San Jose, California ("First Franklin"), a subsidiary of National City Bank of Indiana, Indianapolis, Indiana ("NC Indiana"), that originates home mortgage loans, including subprime loans Commenters also asserted, based on data reported under the HMDA, that National City engages in discriminatory treatment of African-American and Hispanic individuals in its home mortgage lending operations In addition, commenters expressed concern about potential branch closings resulting from this proposal and the percentage of Provident Bank branches in LMI and predominantly minority areas.

B CRA Performance Evaluations

As provided in the CRA, the Board has evaluated the convenience and needs factor in light of the evaluations by the appropriate federal supervisors of the CRA performance records of the relevant insured depository 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 the institution's overall record of performance under the CRA by its appropriate federal supervisor[16] At their most recent CRA evaluations by the OCC, National City Bank, Cleveland ("NC Bank"), National City's largest bank as measured by total deposits, received an "outstanding" rating, and NC Indiana, National City's largest bank as measured by total assets, received a "satisfactory" rating[17] In addition, National City's six other subsidiary banks received either "outstanding" or "satisfactory" ratings at their most recent CRA evaluations[18]

The Board has carefully reviewed the CRA performance records of the insured depository institution subsidiaries of National City A summary of the most recent CRA evaluations of NC Bank and NC Indiana was included in the *National City/Allegiant Order* Based on its review of the record in this case, the Board hereby reaffirms and adopts the facts and findings detailed in the *National City/Allegiant Order*

NC Bank's most recent CRA evaluation characterized its overall record of home mortgage and small business lending as excellent[19] and praised the bank's level of community development lending Examiners noted favorably the use of several flexible lending products designed to address affordable housing needs of LMI individuals and commended the bank's level of qualified investments.

reasonably be expected to affect, the safety and soundness of the institutions involved in this proposal or other factors that the Board must consider under the BHC Act

14. 12 USC §2901 *et seq*

15 12 USC §2801 *et seq*

16 *See Interagency Questions and Answers Regarding Community Reinvestment*, 66 *Federal Register* 36,620 and 36,639 (2001)

17 Both ratings are as of February 22, 2000

18 Appendix C lists the most recent CRA ratings of National City's bank subsidiaries, including the recently acquired Allegiant Bank, St Louis, Missouri

19 In evaluating the records of performance under the CRA of NC Bank and NC Indiana, examiners considered home mortgage loans by certain affiliates in the banks' assessment areas The loans reviewed by examiners included loans reported by National City Mortgage Corporation, Miamisburg, Ohio ("NC Mortgage") (a subsidiary of NC Indiana), National City Mortgage Services, Kalamazoo, Michigan ("NC Mortgage Services") (a subsidiary of National City Bank of Michigan/Illinois, Bannockburn, Illinois), and other bank and nonbank affiliates of NC Bank

In addition, examiners reported that NC Bank's community development services were excellent and praised the distribution of the bank's branches At NC Indiana's most recent CRA performance evaluation, examiners commended the bank's record of home mortgage lending among borrowers of different income levels and its community development lending NC Indiana's most recent evaluation also commended its strong level of qualified investments and characterized the distribution of the bank's branches throughout its assessment area, including LMI geographies, as excellent.

Provident Bank, Provident's only subsidiary bank, received an "outstanding" rating at its most recent CRA performance evaluation by the Federal Reserve Bank of Cleveland, as of March 11, 2002 National City has indicated that its CRA and consumer compliance programs would be implemented at Provident on consummation of the proposal

At Provident Bank's most recent CRA performance evaluation, examiners concluded that the bank's lending activity reflected an excellent responsiveness to assessment-area credit needs Examiners commended Provident Bank's home mortgage lending record and noted that it demonstrated an excellent geographic distribution of HMDA-reportable loans, especially in LMI areas and among borrowers of different incomes. They also reported that the bank had a good geographic distribution of small business loans In addition, examiners commended the bank for its significant level of community development lending and investments and reported that such investments supported the development of LMI housing. They indicated that Provident Bank has taken a leadership role in community development services, noting that the bank provides services that promote affordable housing and economic development In addition, examiners stated that Provident Bank's branches and automated teller machines are reasonably accessible to all segments of the bank's assessment areas.

C. HMDA Data, Subprime Lending, and Fair Lending Record

The Board has carefully considered the lending record of and HMDA data reported by National City in light of public comment Based on their review of HMDA data, commenters primarily contended that National City's lending operations are organized in a manner to direct First Franklin's higher priced loans disproportionately to minority and LMI borrowers and in LMI and predominantly minority communities, as compared with the other subsidiaries of National City engaged in home mortgage lending, including National City's bank subsidiaries, NC Mortgage, and NC Mortgage Services (collectively, "National City Lenders").[20] In addition, commenters criticized other aspects of the lending activities of First Franklin and the National City Lenders [21]

The Board reviewed HMDA data reported by all of National City's bank and nonbank lending subsidiaries in the MSAs identified by the commenters and focused its analysis on the MSAs that comprise the assessment areas of the National City Lenders in Ohio, Illinois, Indiana, Kentucky, and Michigan. The analysis included a comparison of the HMDA data of First Franklin with combined data submitted by the National City Lenders.[22]

An analysis of 2002 HMDA data does not support the contention that National City disproportionately directs First Franklin's loans to minority and LMI borrowers and in LMI and predominantly minority communities as compared with the National City Lenders The 2002 HMDA data indicate that the National City Lenders extended a larger number of HMDA-reportable loans to African-American borrowers than did First Franklin in the MSAs reviewed In addition, the percentage and number of HMDA-reportable loans by the National City Lenders to Hispanics were generally comparable with or exceeded the percentage and number for First Franklin in each of the MSAs reviewed The HMDA data indicate that the percentage of total HMDA-reportable loans made to African-American and Hispanic borrowers and in LMI and minority census tracts[23] by the National City Lenders generally remained the same or increased from 2002 to 2003 The HMDA data also indicate the National City Lenders generally performed favorably when compared with the aggregate lenders. The percentage of total HMDA-reportable loans originated to African-American and Hispanic borrowers by the National City Lenders was comparable to the aggregate lenders in most of the MSAs reviewed

Moreover, the denial disparity ratios[24] of the National City Lenders for African-American and Hispanic applicants for total HMDA-reportable loans were generally comparable to or lower than those of aggregate lenders in a

20 Two commenters asserted that First Franklin's market share is disproportionately concentrated in LMI and predominantly minority areas in Ohio and that the National City Lenders have ignored these areas Another commenter asserted that, in 2002, First Franklin originated a higher volume and a larger percentage of its HMDA-reportable loans to African-American or Hispanic borrowers than NC Bank The commenter compared 2002 HMDA data reported by First Franklin and NC Bank in the Metropolitan Statistical Areas ("MSAs") of Cincinnati, Columbus, and Dayton, but did not include HMDA data reported by other National City lending subsidiaries in those areas

21 Commenters criticized First Franklin's use of loan brokers to distribute its products, including the payment of yield spread premiums to brokers Another commenter criticized the level of due diligence performed by Provident in providing warehouse lines of credit to subprime lenders and criticized National City for financing payday lending operations

22 The Board analyzed HMDA data for 2001 through 2003 for National City and HMDA data for 2001 and 2002 for the aggregate of lenders in the areas reviewed ("aggregate lenders") The 2003 HMDA data are preliminary and 2003 data for the aggregate lenders are not yet available

23 For purposes of this HMDA analysis, minority census tract means a census tract with a minority population of 80 percent or more

24 The denial disparity ratio equals the denial rate for a particular racial category (for example, African American) divided by the denial rate for whites

majority of the MSAs reviewed.[25] In addition, the National City Lenders' origination rates for total HMDA-reportable loans to Hispanics and African Americans were comparable to or exceeded the rates for aggregate lenders in each of the MSAs reviewed.[26]

The Board 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 only limited information about covered loans. Because of the limitations of HMDA data, the Board has considered these data carefully in light of other information, including public and confidential supervisory information, information on the use of loan brokers by First Franklin to distribute its loans, and information submitted by National City on its policies and procedures to ensure compliance with fair lending laws and to guard against abusive lending practices.

Examiners found no evidence of prohibited discrimination or other illegal credit practices at any of National City's subsidiary banks or the lending subsidiaries of these banks at their most recent CRA performance evaluations. The Board also consulted with the OCC, which has responsibility for enforcing compliance with fair lending laws by national banks and their subsidiaries, about this proposal, the comments received by the Board criticizing the lending activities of First Franklin, and the record of performance of National City's banks and their subsidiaries since the last examination.

As discussed in the *National City/Allegiant Order*, National City has taken several affirmative steps to ensure compliance with fair lending laws and to prevent abusive lending practices at First Franklin and the National City Lenders. National City represented that all loan applicants are evaluated individually on their credit qualifications and the loans they receive are based on those qualifications. National City has a centralized compliance function and has implemented corporate-wide compliance policies and procedures to help ensure that all the business lines of National City, including First Franklin, comply with fair lending and other consumer protection laws and regulations. Compliance officers and staff are responsible for compliance training and monitoring. National City also conducts file reviews for compliance with federal and state consumer protection rules and regulations for all product lines and origination sources, including First Franklin. In addition, National City regularly performs self-assessments of its fair lending law compliance and fair lending policy training for its employees. National City represented that its corporate consumer compliance program will be implemented at Provident Bank after consummation of the proposal.[27]

The Board also reviewed the use of loan brokers by First Franklin in distributing its loan products and concluded that this practice does not appear to have resulted in the disparate treatment of minorities or LMI individuals. National City represented that First Franklin has implemented a detailed program for establishing relationships with brokers, which includes the review of a prospective broker's license status, financial condition, and background. In addition, National City stated that, although the National City Lenders and First Franklin have relationships with brokers and correspondents that provide subprime credit as some portion of their business, National City does not pursue business relationships with brokers or correspondents that originate subprime loans exclusively. National City also represented that loan brokers are not chosen based on their geographic location or the income, race, or ethnicity of residents in the brokers' locations.

The Board also has considered the HMDA data, subprime lending, and fair lending record of National City in light of other information, including the CRA performance records of National City's subsidiary banks discussed above and in the *National City/Allegiant Order*, and public comment. These records demonstrate that National City is active in helping to meet the credit needs of its entire community.

D. Branch Closings

One commenter expressed concern about the effect of branch closings that might result from this proposal. The Board has considered those concerns in light of all the facts of record. National City represented that it is in the process of determining whether to close branches in markets where there is overlap and that any closures or consolidations of branches will be conducted in accordance with National City's Branch Closing Policy and Procedures. The Board carefully considered National City's branch closing policy and its record of opening and closing branches in the *National City/Allegiant Order*. In addition, examiners reviewed National City's branch closing policy as part of the most recent CRA evaluations of each of National City's banks and found that it complied with federal law.

The Board also has considered the fact that federal banking law provides a specific mechanism for addressing

25. Two commenters also alleged that the denial disparity ratios of some of National City's bank subsidiaries in certain markets indicated that the banks disproportionately denied African-American or Hispanic applicants for home mortgage loans.

26. The origination rate equals the total number of loans originated to applicants of a particular racial category divided by the total number of applications received from members of that racial category.

27. Based on a review of a sample of First Franklin's loans that ended in foreclosure, one commenter expressed concern about certain terms, such as high interest rates with balloon payments, prepayment penalties, and adjustable interest rates, including "teaser rates," and other lending practices of First Franklin. In addition, commenters criticized National City for not having procedures for referring to the National City Lenders loan applicants of First Franklin who qualify for credit at those affiliates. As discussed above, National City has represented that all loan applicants are evaluated individually on their credit qualifications and the loans they receive are based on those qualifications. In addition, National City has a substantial compliance program in place to ensure that First Franklin does not engage in abusive lending practices. The Board also notes that the terms of loans offered by First Franklin that were criticized by the commenter are not, in and of themselves, abusive, and the fact that some of these terms are present in foreclosed loans does not itself indicate that these terms are inappropriate or abusive.

branch closings.[28] Federal law requires an insured depository institution to provide notice to the public and to the appropriate federal supervisory before closing a branch. In addition, the Board notes that the OCC, as the appropriate federal supervisor of NC Bank, will continue to review the bank's branch closing record in the course of conducting CRA performance evaluations.

E. Conclusion on Convenience and Needs Factor

The Board has carefully considered all the facts of record, including reports of examination of the CRA records of the institutions involved, information provided by National City, public comments on the proposal, and confidential supervisory information. Based on a review of the entire record, and for the reasons discussed above and in the *National City/Allegiant Order*, the Board concludes that considerations relating to the convenience and needs factor, including the CRA performance records of the relevant depository institutions, are consistent with approval.

Nonbanking Activities

National City also has filed a notice under sections 4(c)(8) and 4(j) of the BHC Act to acquire Provident Investment Advisors, Inc., also in Cincinnati ("Investment Advisors"), which engages in investment advisory activities. The Board has determined by regulation that this activity is permissible for bank holding companies under the Board's Regulation Y,[29] and National City has committed to conduct these activities in accordance with the Board's regulations and orders for bank holding companies engaged in these activities.

To approve the notice, the Board must determine that National City's acquisition of Investment Advisors and the performance of the proposed activities "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."[30] As part of its evaluation of these factors, the Board has considered the financial and managerial resources of National City, its subsidiaries, and the company to be acquired, and the effect of the proposed transaction on those resources. For the reasons noted above, and based on all the facts of record, the Board concludes that financial and managerial considerations are consistent with approval of the notice.

The Board also has considered the competitive effects of National City's proposed acquisition of Provident's nonbanking subsidiary in light of all the facts of record. National City and Provident engage in activities related to investment advice. The market for the activity is regional or national in scope and unconcentrated. The record in this case also indicates that there are numerous providers of these services. Accordingly, the Board concludes that National City's acquisition of Investment Advisors would not have a significantly adverse effect on competition in any relevant market.

National City has indicated that the proposal would allow National City to provide an expanded array of services to individuals, businesses, and governmental units in a wider geographic area and provide customers of Provident a full array of brokerage services. 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 standard of section 4 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.[31] In reaching its conclusion, the Board has considered all the facts of record in light of the factors that it is required to consider under the BHC Act and other applicable statutes.[32] The Board's

---

28. Section 42 of the Federal Deposit Insurance Act (12 U.S.C. § 1831r-1), as implemented by the Joint Policy Statement Regarding Branch Closings (64 *Federal Register* 34,844 (1999)), requires that a bank provide the public with at least 30 days' notice and the appropriate federal supervisory agency and customers of the branch with at least 90 days' notice before the date of the proposed branch closing. The bank also is required to provide reasons and other supporting data for the closure, consistent with the institution's written policy for branch closings.

29. *See* 12 CFR 225.28(b)(6).

30. *See* 12 U.S.C. § 1843(j)(2)(A).

31. A commenter requested that the Board extend the comment period on this proposal. The Board has accumulated a significant record in this case, including reports of examination, supervisory information, public reports and information, and public comment. In the Board's view, interested persons had ample opportunity to submit views on the proposal and, in fact, the commenter has provided written submissions that the Board has considered carefully in acting on this proposal. The commenter's request for additional time to comment does not identify extraordinary circumstances that would justify an extension of the public comment period for this case. Moreover, the BHC Act and Regulation Y require the Board to act on proposals submitted under those provisions within certain time periods. 12 U.S.C. § 1842(b), 12 CFR 225.15(d). Based on a review of all the facts of record, the Board has concluded that the record in this case is sufficient to warrant Board action at this time and that an extension of the comment period is not warranted. Accordingly, the request for an extension of the comment period is denied.

32. Commenters also requested that the Board hold a public meeting or hearing on the proposal. Section 3(b) of the BHC Act does not require the Board to hold a public 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. The Board has not received such a recommendation from the appropriate supervisory authorities. Under its regulations, the Board also may, in its discretion, hold a public meeting or hearing on an application to acquire a bank if a meeting or hearing is necessary or appropriate to clarify factual issues related to the application and to provide an opportunity for testimony. 12 CFR 225.16(e). Section 4 of the BHC Act and the Board's regulations provide for a hearing on a notice to acquire nonbanking companies if there are disputed issues of material fact that cannot be resolved in some other manner. 12 CFR 225.25(a)(2). The Board has considered carefully the commenters' requests in light of all the facts of record. In the Board's view, the commenters had ample opportunity to submit their views and submitted written comments that have been considered carefully by the Board in acting on the proposal. The commenters' requests fail to demonstrate why written comments do not present their evidence

approval is specifically conditioned on compliance by National City with the conditions imposed in this order and the commitments made to the Board in connection with the application and notice, including compliance with state law The Board's approval of the nonbanking aspects of the proposal is also subject to all the conditions set forth in Regulation Y, including those in sections 225 7 and 225 25(c) (12 CFR 225 7 and 225.25(c)), 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 issued thereunder The commitments made to the Board in the application process are deemed to be conditions imposed in writing by the Board in connection with its findings and decisions and, as such, may be enforced in proceedings under applicable law

The acquisition of Provident Bank may not be consummated before the fifteenth calendar day after the effective date of this order, or 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 Cleveland, acting pursuant to delegated authority.

By order of the Board of Governors, effective June 8, 2004

Voting for this action Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn

ROBERT DEV FRIERSON
Deputy Secretary of the Board

Appendix A

Ohio Banking Market Definitions

Cleveland

Cuyahoga, Lake, Lorain, and Geauga Counties, Sagamore Hills, Northfield Center, Twinsburg, Richfield, Boston, and Hudson townships in Summit County, Medina County, excluding Homer, Harrisville, Westfield, Guilford, Wadsworth and Sharon townships, Aurora and Streetsboro townships in Portage County; and the City of Vermillion in Erie County

Columbus

Franklin, Delaware, Fairfield, Licking, Madison, Pickaway, and Union Counties, Perry township in Hocking County, and Thorn township in Perry County.

adequately and fail to identify disputed issues of fact that are material to the Board's decision that would be clarified by a public meeting or hearing For these reasons, and based on all the facts of record, the Board has determined that a public meeting or hearing is not required or warranted in this case Accordingly, the requests for a public meeting or hearing on the proposal are denied

Dayton

Montgomery, Miami, and Greene Counties, Bethel and Mad River townships in Clark County, and Clear Creek, Wayne, and Massie townships in Warren County

Springfield

Clark County, excluding Bethel and Mad River townships

Appendix B

Ohio Banking Markets in which National City and Provident Compete Directly

Cleveland

National City operates the second largest depository institution in the Cleveland banking market, controlling $15 billion in deposits, representing 25 8 percent of market deposits Provident operates the 25th largest depository institution in the market, controlling $65 8 million in deposits, representing less than 1 percent of market deposits On consummation of the proposal, National City would operate the second largest depository institution in the market, controlling deposits of $15 billion, representing approximately 25 9 percent of market deposits The HHI would increase 6 points to 1,990 Thirty-seven bank and thrift competitors would remain in the market

Columbus

National City operates the fourth largest depository institution in the Columbus banking market, controlling $2 3 billion in deposits, representing 8 3 percent of market deposits Provident operates the 40th largest depository institution in the market, controlling $29.4 million in deposits, representing less than 1 percent of market deposits On consummation of the proposal, National City would operate the fourth largest depository institution in the market, controlling deposits of $2.3 billion, representing approximately 8 4 percent of market deposits. The HHI would increase 2 points to 1,996 Fifty-one bank and thrift competitors would remain in the market

Dayton

National City operates the third largest depository institution in the Dayton banking market, controlling $1 4 billion in deposits, representing 15 3 percent of market deposits Provident operates the sixth largest depository institution in the market, controlling $446 5 million in deposits, representing 5 percent of market deposits On consummation of the proposal, National City would operate the second largest depository institution in the market, controlling deposits of $1 8 billion, representing approximately 20 4 percent of market deposits. The HHI would increase 155 points to 1,657 Twenty-six bank and thrift competitors would remain in the market.

Springfield

National City operates the third largest depository institution in the Springfield banking market, controlling $187 million in deposits, representing 19.3 percent of market deposits. Provident operates the seventh largest depository institution in the market, controlling $36.6 million in deposits, representing 3.8 percent of market deposits. On consummation of the proposal, National City would operate the third largest depository institution in the market, controlling $223.5 million in deposits, representing approximately 23.1 percent of market deposits. The HHI would increase 146 points to 1,967. Eight bank and thrift competitors would remain in the market.

Appendix C

CRA Performance Evaluations of National City

Subsidiary Bank	CRA Rating	Date	Supervisor
1. National City Bank, Cleveland, Ohio	Outstanding	February 2000	OCC
2. National City Bank of Indiana, Indianapolis, Indiana	Satisfactory	February 2000	OCC
3. The Madison Bank and Trust Company, Madison, Indiana	Outstanding	May 1999	FDIC
4. National City Bank of Kentucky, Louisville, Kentucky	Satisfactory	February 2000	OCC
5. National City Bank of Michigan/Illinois, Bannockburn, Illinois	Outstanding	February 2000	OCC
6. National City Bank of Pennsylvania, Pittsburgh, Pennsylvania	Outstanding	February 2000	OCC
7. National City Bank of Southern Indiana, New Albany, Indiana	Satisfactory	February 2000	OCC
8. Allegiant Bank, St. Louis, Missouri	Satisfactory	October 2001	FDIC

New Regions Financial Corporation
Birmingham, Alabama

Regions Financial Corporation
Birmingham, Alabama

Order Approving the Formation of a Bank Holding Company, the Acquisition of a Bank Holding Company and a Savings Association, the Merger of Bank Holding Companies, and Election of Financial Holding Company Status

Regions Financial Corporation ("Regions") has requested the Board's approval under section 3 of the Bank Holding Company Act ("BHC Act")[1] of its proposal to acquire Union Planters Corporation ("Union Planters"), and thereby indirectly acquire its subsidiary banks, Union Planters Bank, National Association ("UPB-NA"), both in Memphis, and Union Planters Bank of the Lakeway Area ("Lakeway Bank"), Morristown, all in Tennessee.[2] Regions proposes to acquire Union Planters through a series of transactions that include the formation of a new bank holding company, New Regions Financial Corporation ("New Regions").[3] New Regions also has filed with the Board an election to become a financial holding company pursuant to sections 4(k) and (*l*) of the BHC Act and section 225.82 of Regulation Y.[4] In addition, New Regions proposes to acquire Union Planters Hong Kong, Inc., also in Memphis, an agreement corporation subsidiary of UPB-NA, pursuant to section 25 of the Federal Reserve Act and section 211.5 of the Board's Regulation K.[5]

1. 12 U.S.C. § 1842.

2. New Regions expects at a later date to merge the subsidiary banks that it would control on consummation of the proposal. The Board's action at this time is limited to reviewing the proposed acquisition under the BHC Act. A subsequent bank merger may require further review under the Bank Merger Act (12 U.S.C. § 1828(c)).

3. In addition, New Regions has filed a notice under sections 4(c)(8) and 4(j) of the BHC Act and section 225.24 of the Board's Regulation Y to acquire Regions Morgan Keegan Trust, F.S.B. ("Regions FSB"), also in Birmingham. 12 U.S.C. §§ 1843(c)(8) and (j), 12 CFR 225.24.

4. 12 U.S.C. §§ 1843(k) & (*l*), 12 CFR 225.82. New Regions would acquire Regions' remaining nonbanking companies under section 4(k) and the post-transaction notice procedures of section 225.87 of Regulation Y (12 CFR 225.87). Union Planters Investment Advisors Inc., also in Memphis, which engages in asset management and investment advisory services, and Union Planters' interest in FundsXpress, Inc., Austin, Texas, which engages in data processing.

In addition to the financial holding company election by New Regions, two Union Planters mid-tier bank holding companies, Union Planters Holding Corporation in Memphis ("UPHC") and Franklin Financial Group Incorporated in Morristown ("Franklin Financial"), have elected to become financial holding companies. On consummation of the proposal, New Regions would operate UPHC and Franklin Financial as direct subsidiaries.

5. 12 U.S.C. § 601 *et seq.*, 12 CFR 211.5.

Notice of the proposal, affording interested persons an opportunity to submit comments, has been published (69 *Federal Register* 9,828 (2004)). 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 the BHC Act

Regions, with total consolidated assets of approximately $48.9 billion, is the 27th largest depository organization in the United States,[6] controlling deposits of approximately $31 9 billion, which represents less than 1 percent of total deposits in insured depository institutions in the United States [7] Regions operates subsidiary depository institutions in Alabama, Arkansas, Florida, Georgia, Louisiana, North Carolina, South Carolina, Tennessee, and Texas

Union Planters, with total consolidated assets of approximately $31 5 billion, is the 39th largest depository organization in the United States, controlling deposits of $22 8 billion, which represents less than 1 percent of total deposits in insured depository institutions in the United States Union Planters operates depository institutions in Alabama, Arkansas, Florida, Illinois, Indiana, Iowa, Kentucky, Louisiana, Mississippi, Missouri, Tennessee, and Texas It also engages in a broad range of permissible nonbanking activities nationwide

On consummation of the proposal, New Regions would become the 21st largest depository organization in the United States, controlling deposits of approximately $54 8 billion, with total consolidated assets of approximately $80 4 billion, and would control less than 1 percent of total deposits in insured depository institutions in the United States The combined organization would operate under the name of Regions Financial Corporation

Interstate Analysis

Section 3(d) of the BHC Act 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 the bank holding company if certain conditions are met For purposes of the BHC Act, the home state of New Regions will be Alabama,[8] and Union Planters' subsidiary banks are located in Alabama, Arkansas, Florida, Illinois, Indiana, Iowa, Kentucky, Louisiana, Mississippi, Missouri, Tennessee, and Texas [9]

All the conditions for an interstate acquisition enumerated in section 3(d) of the BHC Act are met in this case Regions currently is, and New Regions would be on consummation of this proposal, adequately capitalized and adequately managed, as defined by applicable law [10] Each subsidiary bank of Union Planters located in a state with a minimum age requirement has been in existence and operated continuously for at least the period of time required by applicable state law [11] On consummation of the proposal, New Regions and its affiliates would control less than 30 percent, or the applicable percentage established by state law, of total deposits held in each of these states by insured depository institutions Section 3(d) requires review of a state deposit cap in each state in which both Regions and Union Planters currently are located [12] All other requirements of section 3(d) would be met in this case Accordingly, based on 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 a proposal that would result in a monopoly or would be in furtherance of any attempt to monopolize the business of banking in any relevant banking market The BHC Act also prohibits the Board from approving a proposed bank acquisition that would substantially lessen competition in any relevant banking market unless 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 [13]

Regions and Union Planters compete directly in 21 local banking markets, primarily in Alabama, Arkansas, Florida, Louisiana, Tennessee, and Texas [14] The Board has reviewed the competitive effects of the proposal in each of these banking markets in light of all the facts of record In particular, the Board has considered the number of competitors that would remain in the markets, the relative shares of total deposits in depository institutions in the markets ("market deposits") controlled by Regions and Union Planters,[15] the concentration level of market deposits and the increase in this level as measured by the Herfindahl–Hirschman Index ("HHI") under the Depart-

6 Asset data are as of March 31, 2004, and national ranking data are as of December 31, 2003

7 Deposit data are as of June 30, 2003, and reflect the total of the deposits reported by each organization's insured depository institutions in their Consolidated Reports of Condition and Income for June 30, 2003 In this context, insured depository institutions include commercial banks, savings banks, and savings associations

8 A bank holding company's home state is the state in which the total deposits of all subsidiary banks of the company were the largest on July 1, 1966, or the date on which the company became a bank holding company, whichever is later 12 U S C § 1841(o)(4)(C)

9 For purposes section 3(d), the Board considers a bank to be located in the states in which the bank is chartered or headquartered or operates a branch *See* 12 U S C §§ 1841(o)(4)–(7) and 1842(d)(1)(A) and (d)(2)(B)

10 *See* 12 U S C § 1842(d)(1)(A)

11 *See* 12 U S C § 1842(d)(1)(B)

12 *See* 12 U S C § 1842(d)(2)(A) and (B) *See* Ark Code § 23-48-406(a) (2004), Fla Stat Ann § 658 295(8)(b) (2004), Tenn Code Ann § 45-2-1404 (2004), and Tex Code Ann § 203 002(a) (2004)

13 *See* 12 U S C § 1842(c)(1)

14 These banking markets are described in appendix A

15 Market share data are as of June 30, 2003, and are based on calculations in which the 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), *National City Corporation*, 70 *Federal Reserve Bulletin* 743 (1984) Thus, the Board regularly has included thrift deposits in the market share calculation on a 50 percent weighted basis *See, e g , First Hawaiian, Inc* , 77 *Federal Reserve Bulletin* 52 (1991)

ment of Justice Merger Guidelines ("DOJ Guidelines"), and other characteristics of the markets [16]

Consummation of the proposed acquisition of Union Planters would be consistent with Board precedent and DOJ Guidelines in each of the banking markets affected by the proposal. After consummation, one banking market would be considered unconcentrated, eleven banking markets would be considered moderately concentrated, and nine banking markets would be considered highly concentrated, but with only small or modest increases in concentration [17] Of the banking markets that would be considered highly concentrated after consummation of the proposal, all but the Newport, Arkansas, banking market ("Newport banking market") would have several competitors remaining in the market In the Newport banking market, the HHI would increase by only 106 points After consummation of the proposal, New Regions would control approximately 23 4 percent of market deposits, while its two remaining competitors in the market would control 53 8 percent and 22 7 percent of market deposits

The Department of Justice has reviewed the proposal and advised the Board that consummation would not likely have a significantly adverse effect on competition in any relevant market The Board has requested the views of the Office of the Comptroller of the Currency ("OCC") and the Office of Thrift Supervision ("OTS") on the competitive effects of the proposal. No agency has indicated that the proposal raises competitive issues

Based on all the facts of record, the Board concludes that consummation of the proposal would not have a significantly adverse effect on competition or on the concentration of banking resources in any relevant banking market. Accordingly, the Board has determined that competitive considerations are consistent with approval

Financial, Managerial, and Other Supervisory Factors

In applications and notices involving the acquisition of bank holding companies and their insured depository institutions, the BHC Act requires the Board to consider the financial and managerial resources and future prospects of the companies and depository institutions involved in the proposal and certain other supervisory factors The Board has considered, among other things, confidential reports of examination, other confidential supervisory information from the primary federal supervisors for the depository institutions controlled by Regions and Union Planters, and public comments on the proposal [18]

Regions, Union Planters, and their subsidiary depository institutions currently are well capitalized and well managed, and New Regions and each depository institution that it would control would be well capitalized on consummation of the proposal In addition, the Board has consulted with the OCC, the Federal Deposit Insurance Corporation ("FDIC"), and the OTS, the primary federal supervisors of UPB-NA, Lakeway Bank, and Regions FSB, respectively, on the proposal [19] The Board also has considered Regions' plans to implement the proposed acquisition, including its available managerial resources and Regions' record of successfully integrating acquired institutions into its existing operations. Based on all the facts of record, the Board has concluded that considerations relating to the financial and managerial resources and future prospects of New Regions and the depository institutions involved in the proposal are consistent with approval, as are the other supervisory factors under the BHC Act [20]

Convenience and Needs Considerations

In acting on a proposal under section 3 of the BHC Act, the Board is required to consider the effects of the proposal on the convenience and needs of the communities to be served and to take into account the records of the relevant insured depository institutions under the Community Reinvestment Act ("CRA") [21] The Board also reviews the records of performance under the CRA of the relevant depository institutions when acting on a notice under section 4 of the BHC Act to acquire an insured savings association The CRA requires the federal financial supervisory agencies to encourage financial institutions to help meet the credit needs of the local communities in which they operate, consistent with their safe and sound operation, and requires

16 Under the DOJ Guidelines, 49 *Federal Register* 26,823 (1984), a market is considered unconcentrated if the post-merger HHI is less than 1000, moderately concentrated if the post-merger HHI is between 1000 and 1800, and highly concentrated if the post-merger HHI is more than 1800 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 Department of Justice has stated that the higher than normal HHI thresholds for screening bank mergers for anticompetitive effects implicitly recognize the competitive effects of limited-purpose lenders and other nondepository financial institutions

17 Market data for these banking markets are provided in appendix B

18 Onter suggested that the Board encourage Regions Bank, also in Birmingham, to commit to a supplier diversity program and to provide representation by Florida residents in its management that is commensurate with the bank's share of state deposits Although the Board fully supports programs designed to promote equal opportunity and economic opportunities for all members of society, the comments about supplier diversity programs are beyond the factors the Board is authorized to consider under the BHC Act *See, e g*, *Deutsche Bank AG*, 86 *Federal Reserve Bulletin* 509, 513 (1999) The Board also notes that federal banking laws do not impose residency requirements on the management of bank holding companies As described above, the Board has carefully considered the competence and experience of Regions' management in its review of the proposal

19 The Board is the primary federal supervisor of Regions Bank

20 commenter asserted that a UPB-NA subsidiary has originated loans to a company that is controlled by an individual with alleged connections to organized crime This assertion was based on allegations in press reports from 1999 and 2000 that cite determinations in 1980 and 1992 by the New Jersey Casino Control Commission The allegations appear to involve the individual's business transactions and activities during the 1960s and 1970s The Board has carefully reviewed these allegations in light of all facts of record, including relevant reports of examination by federal regulators, and has consulted the OCC concerning the relationship between the UPB-NA subsidiary and the company involved

21 12 U S C § 2901 *et seq*

the appropriate federal financial supervisory agency to take into account an institution's record of meeting the credit needs of its entire community, including low- and moderate-income ("LMI") neighborhoods, in evaluating bank expansionary proposals

The Board has considered carefully the convenience and needs factor and the CRA performance records of the subsidiary depository institutions of Regions and Union Planters in light of all the facts of record, including public comments on the proposal Three commenters opposed the proposal and collectively asserted that

(i) Regions' and Union Planters' subsidiary banks have inadequate or inconsistent records of making qualified investments under the CRA in the communities that they serve,
(ii) Regions engages in an insufficient volume of small business lending in amounts of $100,000 or less in certain markets, and
(iii) Regions should provide more prime-rate home mortgage loans to LMI and minority individuals, small business loans to businesses owned by minority individuals or women, economic development investments, and charitable donations to underserved communities [22] Commenters also asserted that data reported under the Home Mortgage Disclosure Act ("HMDA")[23] indicate that Regions and Union Planters engage in disparate treatment of African-American and Hispanic individuals in their home mortgage lending operations In addition, one commenter expressed concern about possible branch closings after consummation of the proposal [24]

22 One commenter suggested that, in light of Regions' share of Florida deposits, the Board should encourage or require Regions to become the regional leader for each of these lending categories or activities In addition, the commenter contended that the Board should not approve the proposal because Regions had not made a CRA-related commitment to minority communities in Florida The Board has consistently found that neither the CRA nor the federal banking agencies' CRA regulations require depository institutions to make pledges or enter into commitments or agreements with any organization *See, e g , Bank of America Corporation*, 90 *Federal Reserve Bulletin* 217 (2004), *Citigroup Inc* , 88 *Federal Reserve Bulletin* 485 (2002) The commenter also suggested that Regions should commit a specific percentage of its pretax profits to philanthropic contributions in light of its share of Florida deposits The Board notes that neither the CRA nor the agencies' implementing rules require that financial institutions engage in any type of philanthropy

23 12 U.S.C § 2801 *et seq*

24 This commenter also expressed concern about Regions Bank and a UPB-NA subsidiary allegedly financing payday and car-title lending companies Regions responded that Regions Bank and Union Planters have depository relationships with, and provide warehouse credit facilities to, entities engaged in payday and car-title lending These payday and car-title lenders are licensed by the states where they operate and are subject to applicable state law Regions stated that neither it nor Union Planters plays any role in the lending practices or credit review processes of their payday and car-title lender customers The record in this case does not indicate that Regions, Union Planters, or any direct or indirect subsidiary of either organization engages in payday or car-title lending activities directly or through agency arrangements

A. CRA Performance Evaluations

As provided in the CRA, the Board has evaluated the convenience and needs factor in light of the evaluations by the appropriate federal supervisors of the CRA performance records of the insured depository institutions of both organizations 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 institution's overall record of performance under the CRA by its appropriate federal supervisor.[25]

Regions Bank received a "satisfactory" rating at its most recent CRA performance evaluation by the Federal Reserve Bank of Atlanta, as of October 22, 2001 [26] In addition, Union Planters' largest subsidiary bank, UPB-NA, received a "satisfactory" rating at its most recent CRA performance evaluation by the OCC, as of December 31, 1999 Union Planters also controls Lakeway Bank, which received a "satisfactory" rating at its most recent CRA performance evaluation by the FDIC, as of June 11, 2001

New Regions has represented that it would continue the existing CRA program of each depository institution after consummation of this proposal

B. CRA Performance of Regions Bank

As noted above, Regions Bank received an overall "satisfactory" rating for performance under the CRA.[27] Examiners found that Regions Bank exhibited a good level of responsiveness to the credit and community development needs of its overall assessment area In particular, examiners commended the bank's loan distribution in LMI geographies for HMDA-reportable and small business loans [28] Examiners also favorably noted Regions Bank's use of flexible lending programs to serve the credit needs of its overall assessment area, noting that the bank originated almost 3,000 loans totaling more than $242 million under those programs during its CRA evaluation period.

In addition, Regions Bank originated or purchased more than 6,700 HMDA-reportable loans totaling approximately $468 million to borrowers in LMI census tracts and more than 13,500 such loans totaling approximately $672 mil-

25 *See Interagency Questions and Answers Regarding Community Reinvestment*, 66 *Federal Register* 36,620 and 36,639 (2001)

26 Regions FSB, the only other insured depository institution controlled by Regions, is not examined by the OTS for CRA performance because it engages only in trust activities

27. As part of the 2001 performance evaluation, 16 of Regions Bank's 91 assessment areas received full-scope reviews The overall rating for Regions Bank is a composite of the bank's state ratings, which were derived from the full-scope reviews of its assessment areas The evaluation period was January 1, 2000, through June 30, 2001

28 In this context, "small loans to businesses" are loans with original amounts totaling $1 million or less and "small business loans" are business loans in amounts of $1 million or less

lion to LMI individuals during the evaluation period[29] It also originated or purchased more than 8,400 small business loans totaling approximately $697 million to businesses in LMI census tracts Examiners noted that the bank originated almost $50 million in community development loans during the evaluation period, thereby exhibiting an adequate level of community development lending

During 2002 and 2003, Regions Bank originated or purchased more than 88,000 HMDA-reportable loans totaling approximately $9 3 billion, and more than 71,000 small business loans totaling almost $7 5 billion in its overall assessment area[30] During the same time period, Regions Bank also engaged in a significant volume and amount of community development lending The bank originated or purchased 479 community development loans totaling approximately $673 million in its overall assessment area These loans generally were to entities engaged in the construction and renovation of affordable housing in LMI areas, for LMI individuals, or for senior citizens

Examiners characterized as excellent the bank's volume of qualified community development investments and grants They reported that Regions Bank made qualified investments totaling approximately $166 million and provided an additional $4 3 million in grants and contributions during its CRA evaluation period, thereby contributing to the bank's overall qualified investment portfolio of approximately $7 9 billion, as of September 2001 In addition, examiners commended Regions Bank's extensive use of investments to support community development initiatives both inside and outside the bank's assessment areas Examiners also praised the bank for frequently acting as a leading investor in or grantor to various community development initiatives that did not routinely receive private funding

Since its most recent CRA performance evaluation, Regions Bank has initiated several efforts to further strengthen its overall investment performance The bank created the CRA Investment Committee to assess investment opportunities in all the bank's assessment areas Regions Bank has also designated community development managers for each state where the bank operates These managers work with community development organizations in their respective states to identify and pursue lending, investment, and service opportunities

During the period 2001 through 2003, Regions Bank invested approximately $214.5 million in qualified low-income-housing tax credits and $2 million in qualified community development projects or entities throughout its overall assessment area For example, the bank made direct investments in 2002 that provided technical and financial assistance to nonprofit community development corporations, minority-owned small businesses, and other community organizations in Alabama Regions Bank was also a founding member of an organization designed to address a critical need for affordable housing in central Alabama and made an equity investment in and a charitable contribution to this organization totaling $1 million during this period

Examiners noted that 18 percent of the bank's branches were in LMI census tracts, which reasonably correlated with the percentage of families and businesses throughout Regions Bank's combined assessment area that were in LMI census tracts Examiners considered Regions Bank's branches and alternative delivery systems, including ATMs, to be reasonably accessible to bank customers and the bank's hours of operation to be convenient for essentially all portions of its overall assessment area They also noted that Regions Bank provided an adequate level of community development services, which included efforts by board members, officers, and employees of the bank to use their financial expertise to provide financial services that benefited the residents of its overall assessment area Examiners found that the bank's community development services were highly responsive to affordable housing needs

C. CRA Performance of Union Planters Bank

As noted above, UPB-NA received an overall "satisfactory" rating for performance under the CRA from the OCC, as of December 1999[31] During its CRA evaluation period, UPB-NA purchased and originated more than 17,000 HMDA-reportable loans totaling approximately $1 5 billion in the six MSAs that represented approximately 63 percent of UPB-NA's deposits ("Representative MSAs")[32] Examiners noted that UPB-NA's overall lending record demonstrated an adequate distribution of loans to LMI borrowers and borrowers in LMI census tracts. During the evaluation period, the bank's percentage of home purchase and home improvement loans to borrowers in LMI areas generally exceeded the percentage of owner-occupied homes in those areas Examiners determined that

29 Examiners included the HMDA-reportable lending by Regions Mortgage, Inc , Montgomery, Alabama ("RMI"), in their assessment of Regions Bank's CRA performance

30 A commenter criticized the percentage of Regions Bank's small business loans originated in amounts of less than $100,000 in Arkansas, Louisiana, and Mississippi, stating that such loans were needed the most by minority- and female-owned businesses Based on 2002 data on small business lending for the portions of Arkansas and Louisiana included in Regions Bank's combined assessment area, small business loans of $100,000 or less comprised 81 5 percent and 75 5 percent, respectively, of the bank's small business loan originations in those states Although Mississippi is outside Regions Bank's combined CRA assessment area, the Board considered the bank's statewide small business lending data for 2002 The data indicate that 56 6 percent of the small business loans originated by the bank in Mississippi were in amounts of $100,000 or less Examiners reviewed the geographic distribution of small business loans and the distribution of loans to businesses of different sizes and considered these distributions acceptable

31 UPB-NA's 1999 CRA performance rating was a composite of the ratings for the bank's two multistate Metropolitan Statistical Areas ("MSAs") and twelve states The bank's state ratings were based on the assessment areas in each state receiving full-scope reviews The evaluation period was January 1, 1998, through December 31, 1999

32 These areas are the Miami and Ft Lauderdale, Florida, MSAs (17 5 percent of UPB-NA's deposits), the Nashville, Tennessee, MSA (14 percent of UPB-NA's deposits), the St Louis, Missouri/Illinois, MSA (12 percent of UPB-NA's deposits), the Memphis, Tennessee/Arkansas/Mississippi, MSA (10 percent of UPB-NA's deposits), and the Jackson, Mississippi, MSA (9 7 percent of UPB-NA's deposits)

UPB- NA's distribution of HMDA-reportable loans in LMI census tracts was adequate or better in four of the six Representative MSAs and that its distribution of such loans to LMI individuals was good or excellent in four of the six Representative MSAs.

UPB-NA purchased or originated more than 7,200 small loans to businesses totaling approximately $660 million in the Representative MSAs during the evaluation period. Examiners found that UPB-NA's record for originating and purchasing such loans showed good geographic distribution in these areas, including LMI communities. Examiners noted that UPB-NA's level for originating small loans to businesses in LMI census tracts was adequate or better in all six Representative MSAs, with an excellent level of distribution in four of the six Representative MSAs. In the four Representative MSAs where small loans to farms comprised a material portion of the bank's lending record, UPB-NA originated or purchased approximately 580 such loans totaling almost $31 million during its CRA evaluation period.[33]

Examiners stated that UPB-NA's volume and amount of community development lending activities positively affected the bank's lending ratings in five of the six Representative MSAs. Examiners found that UPB-NA originated 47 community development loans in the Representative MSAs totaling approximately $44 million during the CRA evaluation period. These loans primarily supported affordable housing initiatives for LMI individuals and other kinds of initiatives to revitalize LMI census tracts.

According to information provided by Regions, UPB-NA originated or purchased in its overall assessment area almost 160,000 HMDA-reportable loans totaling more than $15.5 billion and almost 60,700 small business loans totaling approximately $5.8 billion during the period 2000 through 2003. Regions also represented that UPB-NA originated almost 260 community development loans totaling more than $137 million in its combined assessment area during the same time period. Excluding loans in multistate MSAs, these loans totaled more than $45 million in Mississippi, more than $17 million in Tennessee, and more than $6.5 million in Louisiana. UPB-NA's community development loans generally supported the construction of housing for LMI individuals, including elderly and disabled low-income individuals.

During the evaluation period, UPB-NA made more than 130 qualified investments totaling approximately $47 million in the Representative MSAs, primarily in securities backed by affordable housing mortgages. UPB-NA also made qualified investments in these MSAs in support of local community organizations dedicated to providing affordable housing and other community service and revitalization initiatives that benefited LMI census tracts and individuals.

Regions represented that UPB-NA made more than 1,200 investments totaling more than $23 million in CRA qualified projects in its assessment areas during the period 2000 through 2003. These investments totaled more than $750,000 in Florida, more than $7 million in Mississippi, and more than $5 million in Tennessee. Many of the investments were in the form of grants or donations to organizations serving the needs of LMI individuals and communities.[34]

Examiners noted that the bank's branches and ATMs were generally accessible to the communities it serves. They also noted, however, that UPB-NA provided few community development services in its assessment areas during the CRA evaluation period.

D. HMDA, Subprime, and Fair Lending Records

The Board has carefully considered the lending records of, and HMDA data reported by, Regions and Union Planters in light of the comments received. Based on a review of 2002 HMDA data, one commenter alleged that Regions has organized its mortgage lending operations in a manner that disproportionately directs higher cost subprime mortgage loans from a Regions Bank subsidiary, EquiFirst Corporation, Charlotte, North Carolina ("EquiFirst"),[35] to minority borrowers as compared with Regions' prime mortgage lending, which is conducted by Regions Bank through RMI.[36] In addition, the commenter alleged that

33. Small loans to farms are loans with original amounts of $500,000 or less. Data on the small loans to farms in these areas do not include the Miami and Ft. Lauderdale MSAs.

34. One commenter criticized UPB-NA's record for making qualified investments in Illinois and Iowa. According to information provided by Regions, UPB-NA has actively pursued qualified investment opportunities in its Illinois and Iowa assessment areas since its most recent CRA performance evaluation. These efforts have resulted in UPB-NA making qualified investments of more than $2 million in Illinois and tripling the amount of its qualified investments in Iowa since the bank's most recent CRA performance evaluation.

35. Regions stated that EquiFirst relies on a network of independent mortgage brokers to originate its loans who use underwriting standards that are commonly accepted in the secondary market and that Regions sells the loans EquiFirst originates in this market. Regions also represented that the brokers in the EquiFirst network offer their clients a variety of prime and subprime mortgage loan products from EquiFirst and other mortgage lenders. In addition, Regions noted that the independent mortgage brokers generally provide their customers with options on available mortgage loan products, including the type of products (prime or subprime) and the provider (EquiFirst or another lender). In particular, Regions represented that EquiFirst does not require its brokers to offer EquiFirst products exclusively.

36. Specifically, the commenter compared 2002 HMDA data reported for RMI and EquiFirst in the following MSAs: Atlanta, Birmingham, Montgomery, New Orleans, Memphis, and Nashville. The commenter asserted that RMI originated mortgage loans to white borrowers in greater volume and with greater frequency than to African-American borrowers in each MSA during 2002. The commenter also made the same allegations about Hispanic borrowers in the Orlando MSA. In addition, this commenter stated that EquiFirst originated a larger number of "higher cost" mortgage loans to minority borrowers than to white borrowers.

As the Board previously has noted, subprime lending is a permissible activity that provides needed credit to consumers who have difficulty meeting conventional underwriting criteria. *See Royal Bank of Canada*, 88 *Federal Reserve Bulletin* 385, 388, n.18 (2002). The Board continues to expect all bank holding companies and their affiliates to conduct their subprime lending operations without any abusive lending practices and in compliance with all applicable laws.

Regions Bank disproportionately denied applications for HMDA-reportable loans by minorities.[37]

The Board reviewed HMDA data reported by Regions Bank, including RMI (collectively, "Regions Prime Lenders") and EquiFirst in the MSAs identified by the commenter and other major markets served by Regions Bank.[38] The Board compared the HMDA data of the Regions Prime Lenders with the data of EquiFirst and the aggregate of lenders ("aggregate lenders") in the MSAs reviewed.[39]

HMDA data for 2002 indicate that in most of the MSAs reviewed, the number of HMDA-reportable loans originated by the Regions Prime Lenders to African Americans as a percentage of their total HMDA lending was lower than the percentage for aggregate lenders. These data also show a more pronounced disparity between the proportion of loans originated by the Regions Prime Lenders to African Americans in the Atlanta MSA and the proportion of loans originated by aggregate lenders. African Americans comprise almost 30 percent of the population in the Atlanta MSA, and the percentage of applications received by the Regions Prime Lenders from African Americans was significantly lower than the percentage for aggregate lenders.[40]

The data also indicate, however, that the percentage of loans extended by the Regions Prime Lenders to African Americans increased modestly in most markets from 2001 to 2002 and again from 2002 to 2003.[41] In addition, the denial disparity ratios[42] decreased from 2001 to 2002 in most of the MSAs. HMDA data in 2002 also indicate that lending by the Regions Prime Lenders to Hispanics was generally comparable to lending by the aggregate lenders in most markets reviewed and exceeded that of the aggregate lenders in the Orlando MSA, the market with the highest percentage of Hispanic individuals.[43]

The Board is concerned when the record of an institution indicates disparities in lending and believes that all banks are obligated to ensure that their lending practices are based on criteria that ensure not only safe and sound lending, but also equal access to credit by creditworthy applicants regardless of race or income level. The Board recognizes, however, 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 only limited information about covered loans.[44] Moreover, HMDA data indicating that one affiliate is lending to minorities or LMI individuals to a greater extent than another affiliate do not, without more information, indicate that either affiliate has engaged in discriminatory lending on a prohibited basis.

Because of the limitations of HMDA data, the Board has considered these data carefully in light of other information, including examination reports that provide on-site evaluations of compliance with fair lending laws by the subsidiary depository institutions of Regions and Union Planters and their lending subsidiaries, including EquiFirst. Examiners found no substantive violations of fair lending laws or regulations or other illegal credit practices at any of the depository institution subsidiaries of either organization or their lending subsidiaries.

In Regions Bank's 2001 consumer compliance examination, examiners found the bank's marketing efforts overall were broad-based and designed to cover all of the bank's markets. As part of this examination, examiners reviewed the bank's lending in minority tracts of the Atlanta MSA.[45] Examiners found no evidence that Regions Bank was deliberately excluding any geographic areas from its HMDA-reportable lending efforts in the Atlanta market and also found that no areas in the Atlanta MSA were excluded from the bank's broad-based marketing efforts.

The record also indicates that Regions has taken several steps to ensure that the lending operations of Regions Bank and its subsidiaries, including EquiFirst, comply with fair lending laws. Regions Bank and its mortgage division have established compliance departments to help ensure compliance with federal and state banking laws and regulations, particularly those related to fair lending and consumer protection. These compliance departments are responsible for implementing fair lending and consumer protection compliance programs and procedures, which include providing annual fair lending training to all bank employees involved in lending transactions, performing a second review of all loan applications before they are denied, and

---

37. Based on an analysis of home purchase lending data for Regions, a commenter also alleged that Regions Bank relies heavily on its "subprime affiliates" to lend to African-American and LMI borrowers in Mississippi. HMDA data for Mississippi MSAs in 2002 indicate that Regions Bank, including RMI, received only five applications from African Americans and only 26 applications from LMI individuals. Neither Regions Bank nor RMI has a branch in Mississippi.

38. The Board's review of the HMDA data for the Regions Prime Lenders included the Mobile and Little Rock/North Little Rock MSAs, as well as the MSAs cited by the commenter.

39. The lending data of the aggregate of lenders represent the cumulative lending for all financial institutions that have reported HMDA data in a given market.

40. During 2002, the Regions Prime Lenders engaged in significant overall volume of mortgage lending in the Atlanta MSA, receiving more than 4,200 loan applications and making more than 3,300 loans.

41. In the Atlanta MSA, the percentage of loans extended by the Regions Prime Lenders to African Americans increased from 2001 to 2002 but decreased from 2002 to 2003.

42. The denial disparity ratio equals the denial rate of a particular racial category (*e.g.*, African Americans) divided by the denial rate for whites.

43. The HMDA data for the Orlando MSA indicate that the Regions Prime Lenders originated a larger number and higher percentage of their HMDA-reportable loans to Hispanics than EquiFirst in 2001 and 2002.

44. The data, for example, do not account for the possibility that an institution's outreach efforts may attract a larger proportion of marginally qualified applicants than other institutions attract and do not provide a basis for an independent assessment of whether an applicant who was denied credit was, in fact, creditworthy. Credit history problems and excessive debt levels relative to income (reasons most frequently cited for a credit denial) are not available from HMDA data.

45. Minority census tract means a census tract with a minority population of 80 percent or more.

conducting regular compliance audits and fair lending reviews of loan documentation by product and business line.

Based on a review of the loans it sold to the Federal National Mortgage Association ("Fannie Mae") during 2002, RMI concluded that measures were needed to increase its originations to minority borrowers. To help achieve this goal, RMI initiated an emerging markets program featuring a Community Lending Alliance ("CLA") involving Fannie Mae to increase RMI's lending in underserved markets. RMI has pledged to use its best efforts to originate $1 billion in mortgage loans in underserved markets between August 8, 2003, and September 2, 2005, through the CLA. Regions represents that according to Fannie Mae, RMI has already closed $725 million in loans under the CLA, almost 20 percent of which were to minority loan applicants, including African Americans.

Regions also represents that EquiFirst, which originates all its loans through mortgage brokers, uses computer software to help ensure compliance with applicable federal and state fair lending laws and regulations. According to Regions, this automated compliance program generates all required disclosures for mortgage loan originations and closings. Regions reports that EquiFirst recently enhanced the software to include stand-alone programs for comparative analyses and "predatory" lending testing to supplement the reviews of EquiFirst's originations already performed by Regions Bank. In addition, EquiFirst staff conducts compliance testing, self-assessments, and audits of a sample of mortgage loan originations each month, and also conducts a second review of all denied mortgage loan applications.

Compliance with fair lending and consumer protection laws at UPB-NA and its consumer-loan affiliates is managed and monitored by each lending department or division separately, with oversight and assistance from the bank's Corporate Compliance division. Generally, UPB-NA's compliance programs and procedures provide for automated testing of loan portfolios for compliance with fair lending laws and regulations and include ongoing automated monitoring of rates of application denials and loan distributions for HMDA-reportable loans to minorities in each market, auditing major bank departments for compliance with all other consumer protection laws every 12 to 18 months, and quarterly automated training in fair lending and consumer protection for all staff involved in the bank's lending process.

Regions stated that, although it has not decided which organization's fair lending policies and programs will be implemented at New Regions, it expects that the New Regions' compliance program would draw from the best practices of the existing compliance programs at both organizations. Regions also indicated that the compliance program for Regions Bank, including RMI, after consummation of the proposal, would include UPB-NA's methodology for reviewing HMDA data, which uses denial disparity ratios and penetration rates for loans to minorities to analyze lending performance in the bank's assessment areas.

The Board also has considered the HMDA data in light of other information, including the CRA performance records of Regions' and Union Planters' subsidiary banks that are detailed above. These established efforts demonstrate that, on balance, the records of performance of Regions and Union Planters in meeting the convenience and needs of their communities are consistent with approval of this proposal. The record in this case also reflects an opportunity for the Regions Prime Lenders to improve the percentage of their overall applications for HMDA-reportable loans from, and the percentage of overall HMDA-reportable originations to, African-American borrowers, particularly in the Atlanta MSA. As noted above, RMI's internal review has identified the need to originate more loans to minority borrowers and it appears to have taken affirmative steps to improve this aspect of its lending operations through its emerging markets initiative that features the CLA with Fannie Mae. The Board also notes that Regions Bank, including RMI, should be better equipped on consummation of the proposal to identify the MSAs where it is underperforming in terms of originating mortgage loans to African Americans after the methodology of its internal analysis of HMDA-reportable lending has been updated. The Board expects that Regions Bank, including RMI, will continue to take steps to improve its mortgage lending performance to African-American borrowers, particularly in the Atlanta MSA. The Federal Reserve System will monitor and evaluate the performance of Regions Bank as part of the supervisory process, including assessments of this performance in subsequent consumer compliance examinations.

E. Branch Closings

A commenter expressed concern that this proposal would result in possible branch closings and requested that Regions identify which branches it would close. The Board has carefully considered these comments in light of all the facts of record. Regions represented that the number of branch closings, relocations, or consolidations related to the proposed acquisition would be small because there is little geographic overlap with Union Planters. Regions also represented that no decision has been made about the number or locations of branches to be closed, relocated, or consolidated, or about which organization's branch closing policy would be in effect at New Regions on consummation of the proposal.

The Board has considered carefully Regions' and UPB-NA's branch closing policies and Regions' record of opening and closing branches. Under their policies, Regions and UPB-NA must review a number of factors before identifying a branch for closure, consolidation, or relocation, including deposit levels, the potential impact on the community, and other relevant factors. Examiners reviewed Regions' branch closing policy as part of the most recent CRA evaluation of Regions Bank and found it to be in compliance with federal law.

The Board also has considered that federal banking law provides a specific mechanism for addressing branch clos-

ings.[46] Federal law requires an insured depository institution to provide notice to the public and to the appropriate federal supervisory agency before closing a branch. In addition, the Board notes that the Reserve Bank and the OCC will continue to review the branch closing record of Regions Bank and UPB-NA, respectively, in the course of conducting CRA performance evaluations.

F. Conclusion on Convenience and Needs Factor

The Board has carefully considered all the facts of record, including reports of examination of the CRA records of the institutions involved, information provided by Regions, comments on the proposal, and confidential supervisory information. Based on a review of the entire record, and for the reasons discussed above, the Board concludes that considerations relating to the convenience and needs factor, including the CRA performance records of the relevant depository institutions, are consistent with approval.

Nonbanking Activities

New Regions also has filed notice under sections 4(c)(8) and 4(j) of the BHC Act to acquire Regions FSB and thereby engage in the activity of operating a savings association. Through Regions FSB, New Regions would accept a small amount of deposits and provide trust and asset management services. The Board has determined by regulation that the activity of owning, controlling, or operating a savings association is permissible for a bank holding company, provided that the savings association directly and indirectly engages only in activities that are permissible for a bank holding company to conduct under section 4(c)(8) of the BHC Act.[47]

In order to approve New Regions' notice to acquire Regions FSB, the Board is required by section 4(j)(2)(A) of the BHC Act to determine that the acquisition "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."[48]

As part of its evaluation of these factors, the Board considers the financial condition and managerial resources of the notificant, its subsidiaries, and the companies to be acquired, and the effect of the proposed transaction on those resources. For the reasons discussed above and based on all the facts of record, the Board has concluded that financial and managerial considerations are consistent with approval of the notice. The Board reviewed the competitive effects of the proposal in the Birmingham banking market. Regions FSB maintains its only office in Birmingham, and Union Planters does not compete in this banking market. Based on all the facts of record, the Board concludes that it is unlikely that significantly adverse competitive effects would result from the acquisition of Regions FSB.

The Board also has reviewed carefully the public benefits of the acquisition of Regions FSB. The record indicates that consummation of the proposed thrift acquisition, when considered in the broader context of Regions' acquisition of Union Planters, would result in benefits to the customers and communities that the institutions serve. On consummation, the proposal would allow Regions to provide customers of Regions FSB, along with the customers of Regions Bank, UPB-NA, Lakeway Bank, and Regions' other direct and indirect subsidiaries, with access to a broader array of commercial banking products and services. Moreover, Regions' customers would have access to an expanded network of branch offices and ATMs.

The Board concludes that the conduct of the proposed nonbanking activities within the framework of Regulation Y and Board precedent is not likely to result in adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices, that would outweigh the public benefits of the proposal, such as increased customer convenience and gains in efficiency. Accordingly, based on all the facts of record, the Board has determined that the balance of public interest factors that the Board must consider under section 4(j)(2)(A) of the BHC Act is consistent with approval of New Region's notice.

As noted above, New Regions also has proposed to acquire Union Planters Hong Kong, Inc. The Board has concluded that all the factors required to be considered under the Federal Reserve Act and Regulation K are consistent with approval.

Financial Holding Company Election

New Regions filed with the Board an election to become a financial holding company pursuant to sections 4(k) and (*l*) of the BHC Act and section 225.82 of Regulation Y. New Regions has certified that the subsidiary depository institutions controlled by Regions and Union Planters are well capitalized and well managed and will remain so on consummation of the proposal. New Regions has provided all the information required for financial holding company election under Regulation Y.

As noted above, the Board has reviewed the examination ratings received by the subsidiary depository institutions controlled by Regions and Union Planters under the CRA and other relevant examinations and information. Based on all the facts of record, the Board has determined that New Regions' election to become a financial holding company will become effective on consummation of the proposal, if on that date Regions Bank, Regions FSB, UPB-NA, and Lakeway Bank remain well capitalized and well managed and all institutions subject to the CRA are

46. Section 42 of the Federal Deposit Insurance Act (12 U.S.C. § 1831r-1), as implemented by the Joint Policy Statement Regarding Branch Closings (64 *Federal Register* 34,844 (1999)), requires that a bank provide the public with at least 30 days' notice and the appropriate federal supervisory agency and customers of the branch with at least 90 days' notice before the date of the proposed branch closing. The bank also is required to provide reasons and other supporting data for the closure, consistent with the institution's written policy for branch closings.

47. 12 CFR 225.28(b)(4).

48. 12 U.S.C. § 1843(j)(2)(A).

rated at least "satisfactory" at their most recent performance evaluations.[49]

Conclusion

Based on the foregoing and in light of all the facts of record, the Board has determined that the applications and notice should be, and hereby are, approved.[50] In reaching this conclusion, the Board has considered all the facts of record in light of the factors that it is required to consider under the BHC Act and other applicable statutes. The Board's approval is specifically conditioned on compliance by New Regions with the conditions in this order and with all the commitments made to the Board in connection with this proposal and the receipt of all other regulatory approvals. The Board's approval of the nonbanking aspects of the proposal also is subject to all the conditions set forth in Regulation Y, including those in sections 225.7 and 225.25(c) of Regulation Y (12 CFR 225.7 and 225.25(c)), 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 issued thereunder. For purposes of these actions, the commitments and conditions 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 bank acquisitions shall not be consummated before the fifteenth calendar day after the effective date of this order, and the proposal may 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 Atlanta acting pursuant to delegated authority.

By order of the Board of Governors, effective June 16, 2004.

Voting for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

ROBERT DEV. FRIERSON
Deputy Secretary of the Board

49. This determination includes the financial holding company elections by UPHC and Franklin Financial, which also will become effective on consummation of the proposal.

50. Two commenters requested that the Board hold a public hearing on the proposal. Section 3 of the BHC Act does not require the Board to hold a public hearing on an application unless the appropriate supervisory authority for any of the banks to be acquired makes a timely written recommendation of denial of the application. The Board has not received such a recommendation from any supervisory authority. Under its rules, the Board also may, in its discretion, hold a public meeting or hearing on an application to acquire a bank if a meeting or hearing is necessary or appropriate to clarify factual issues related to the application and to provide an opportunity for testimony. 12 CFR 225.16(e). In addition, section 4 of the BHC Act and the Board's rules thereunder provide for a hearing on a notice to acquire a nonbanking company if there are disputed issues of material facts that cannot be resolved in some other manner. 12 CFR 225.25(a)(2). The Board has considered carefully the commenters' requests in light of all the facts of record. In the Board's view, the public has had ample opportunity to submit comments on the proposal, and in fact, the commenters have submitted written comments that the Board has considered carefully in acting on the proposal. The commenters' requests fail to identify disputed issues of fact that are material to the Board's decisions that would be clarified by a public hearing or meeting. Moreover, the commenters' requests fail to demonstrate why their written comments do not present their views adequately or why a meeting or hearing otherwise would be necessary or appropriate. 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 in this case. Accordingly, the requests for a public hearing or meeting on the proposal are denied.

Appendix A

Banking Markets in which Regions and Union Planters Compete Directly

Alabama Banking Markets

Decatur

Morgan County, and the portion of the City of Decatur in Limestone County.

Florence

Colbert and Lauderdale Counties.

Huntsville

Madison County, and Limestone County, excluding the Town of Ardmore and the portion of the City of Decatur in Limestone County.

Mobile

Mobile County, and the towns of Bay Minette, Daphne, Fairhope, Loxley, Robertsdale, and Spanish Fort.

Arkansas Banking Markets

Blytheville

Mississippi County, and the towns of Virginia, Holland, Cooter, and Pemiscot.

Corning

Clay County.

Jonesboro

Craighead and Poinsett Counties.

Newport

Jackson County.

Paragould

Greene County.

Florida Banking Market

West Palm Beach

The portion of Palm Beach County east of Loxahatchee, and the towns of Indiantown and Hobe Sound.

Louisiana Banking Markets

Baton Rouge

Ascension, East Baton Rouge, Iberville, Livingston, and West Baton Rouge Parishes; the northern half of Assumption Parish; and the Town of Union in St. James Parish.

Houma–Thibodaux

Lafourche and Terrebonne Parishes.

New Orleans

Jefferson, Orleans, Plaquemines, St. Bernard, St. Charles, St. John the Baptist, and St. Tammany Parishes; and St.James Parish, excluding the Town of Union.

Tennessee Banking Markets

Chattanooga

Hamilton and Marion Counties, excluding the portion of the Town of Monteagle in Marion County; and Catoosa, Dade, and Walker Counties in Georgia.

Clarksville

Montgomery and Stewart Counties; and Christian County in Kentucky.

Cookeville

Jackson, Overton, and Putnam Counties.

Fayetteville

Lincoln County, excluding the portion of the Town of Petersburg in this county.

Knoxville

Anderson, Knox, Loudon, Roane, and Union Counties; the portion of Blount County northwest of Chilhowee Mountain; and the towns of Blaine, Buffalo Springs, Chestnut Hill, Danridge, Dumplin, Friends Station, Harriman, Hodges, Kodak, Joppa, Lea Springs, New Market, Oliver Springs, Powder Springs, Seymour, and Strawberry Plains.

Memphis

Fayette, Shelby, and Tipton Counties; Crittenden County in Arkansas; and De Soto and Tate Counties in Mississippi.

Nashville

Cheatham, Davidson, Robertson, Rutherford, Sumner, Williamson, and Wilson Counties.

Texas Banking Market

Houston

Houston Ranally Metropolitan Area.

Appendix B

Market Data

Unconcentrated Banking Market

Clarksville, Tennessee/Kentucky

Regions operates the 14th largest depository institution in the market, controlling deposits of $13.5 million, representing less than 1 percent of market deposits. Union Planters operates the 13th largest depository institution in the market, controlling deposits of $38.9 million, representing approximately 2.1 percent of market deposits. After the proposed merger, New Regions would operate the 12th largest depository institution in the market, controlling deposits of $52.4 million, representing approximately 2.8 percent of market deposits. Thirteen depository institutions would remain in the banking market. The HHI would increase by 3 points to 977.

Moderately Concentrated Banking Markets

Chattanooga, Tennessee/Georgia

Regions operates the 16th largest depository institution in the market, controlling deposits of $77.6 million, representing approximately 1.4 percent of market deposits. Union Planters operates the 17th largest depository institution in the market, controlling deposits of $71.7 million, representing approximately 1.3 percent of market deposits. After the proposed merger, New Regions would operate the seventh largest depository institution in the market, controlling deposits of $149.3 million, representing approximately 2.6 percent of market deposits. Twenty-four depository institutions would remain in the banking market. The HHI would increase by 4 points to 1343.

Cookeville, Tennessee

Regions operates the 13th largest depository institution in the market, controlling deposits of $31.1 million, representing approximately 2.3 percent of market deposits. Union Planters operates the fifth largest depository institution in the market, controlling deposits of $135.5 million, representing approximately 9.9 percent of market deposits. After the proposed merger, New Regions would operate the fourth largest depository institution in the market, controlling deposits of $166.6 million, representing approximately

12.2 percent of market deposits. Thirteen depository institutions would remain in the banking market. The HHI would increase by 45 points to 1110.

Decatur, Alabama

Regions operates the largest depository institution in the market, controlling deposits of $203.8 million, representing approximately 14.9 percent of market deposits. Union Planters operates the seventh largest depository institution in the market, controlling deposits of $112.8 million, representing approximately 8.3 percent of market deposits. After the proposed merger, New Regions would remain the largest depository institution in the market, controlling deposits of approximately $316.7 million, representing approximately 23.2 percent of market deposits. Thirteen depository institutions would remain in the banking market. The HHI would increase by 246 points to 1425.

Florence, Alabama

Regions operates the eighth largest depository institution in the market, controlling deposits of $116.5 million, representing approximately 6.2 percent of market deposits. Union Planters operates the 12th largest depository institution in the market, controlling deposits of $29.7 million, representing approximately 1.6 percent of market deposits. After the proposed merger, New Regions would operate the sixth largest depository institution in the market, controlling deposits of $146.2 million, representing approximately 7.8 percent of market deposits. Thirteen depository institutions would remain in the banking market. The HHI would increase by 19 points to 1257.

Houma–Thibodaux, Louisiana

Regions operates the fifth largest depository institution in the market, controlling deposits of $157.1 million, representing approximately 6.9 percent of market deposits. Union Planters operates the 11th largest depository institution in the market, controlling deposits of $52.6 million, representing approximately 2.3 percent of market deposits. After the proposed merger, New Regions would operate the fourth largest depository institution in the market, controlling deposits of approximately $209.6 million, representing approximately 9.1 percent of market deposits. Thirteen depository institutions would remain in the banking market. The HHI would increase by 31 points to 1757.

Huntsville, Alabama

Regions operates the largest depository institution in the market, controlling deposits of $913.8 million, representing approximately 21.6 percent of market deposits. Union Planters operates the ninth largest depository institution in the market, controlling deposits of $103.2 million, representing approximately 2.4 percent of market deposits. After the proposed merger, New Regions would remain the largest depository institution in the market, controlling deposits of approximately $1 billion, representing approximately 24 percent of market deposits. Thirteen depository institutions would remain in the banking market. The HHI would increase by 105 points to 1339.

Jonesboro, Arkansas

Regions operates the fourth largest depository institution in the market, controlling deposits of $160.3 million, representing approximately 9 percent of market deposits. Union Planters operates the second largest depository institution in the market, controlling deposits of $199.4 million, representing approximately 11.2 percent of market deposits. After the proposed merger, New Regions would operate the second largest depository institution in the market, controlling deposits of approximately $359.6 million, representing approximately 20.2 percent of market deposits. Fifteen depository institutions would remain in the banking market. The HHI would increase by 202 points to 1713.

Knoxville, Tennessee

Regions operates the 22nd largest depository institution in the market, controlling deposits of $32.2 million, representing less than 1 percent of market deposits. Union Planters operates the seventh largest depository institution in the market, controlling deposits of $462.8 million, representing approximately 5.2 percent of market deposits. After the proposed merger, New Regions would operate the seventh largest depository institution in the market, controlling deposits of $495 million, representing approximately 5.5 percent of market deposits. Thirty-one depository institutions would remain in the banking market. The HHI would increase by 4 points to 1118.

Nashville, Tennessee

Regions operates the 11th largest depository institution in the market, controlling deposits of $463.6 million, representing approximately 2.4 percent of market deposits. Union Planters operates the fourth largest depository institution in the market, controlling deposits of $1.1 billion, representing approximately 5.5 percent of market deposits. After the proposed merger, New Regions would operate the fourth largest depository institution in the market, controlling deposits of approximately $1.5 billion, representing approximately 7.9 percent of market deposits. Thirty-five depository institutions would remain in the banking market. The HHI would increase by 26 points to 1105.

New Orleans, Louisiana

Regions operates the fourth largest depository institution in the market, controlling deposits of $1.3 billion, representing approximately 7.4 percent of market deposits. Union Planters operates the 26th largest depository institution in the market, controlling deposits of $60.5 million, representing less than 1 percent of market deposits. After the proposed merger, New Regions would remain the fourth largest depository institution in the market, controlling deposits

of approximately $1.4 billion, representing approximately 7.8 percent of market deposits. Thirty-eight depository institutions would remain in banking market. The HHI would increase by 5 points to 1628.

West Palm Beach, Florida

Regions operates the 53rd largest depository institution in the market, controlling deposits of $1.3 million, representing less than 1 percent of market deposits. Union Planters operates the 14th largest depository institution in the market, controlling deposits of $274.5 million, representing approximately 1.3 percent of market deposits. After the proposed merger, New Regions would operate the 14th largest depository institution in the market, controlling deposits of approximately $275.8 million, representing approximately 1.3 percent of market deposits. Fifth-five depository institutions would remain in the banking market. The HHI would not increase, remaining at 1325.

Highly Concentrated Banking Markets

Baton Rouge, Louisiana

Regions operates the sixth largest depository institution in the market, controlling deposits of $288.6 million, representing approximately 3.5 percent of market deposits. Union Planters operates the fourth largest depository institution in the market, controlling deposits of $638.5 million, representing approximately 7.7 percent of market deposits. After the proposed merger, New Regions would operate the third largest depository institution in the market, controlling deposits of $927.1 million, representing approximately 11.1 percent of market deposits. Thirty-two depository institutions would remain in the banking market. The HHI would increase by 53 points to 1832.

Blytheville, Arkansas

Regions operates the fifth largest depository institution in the market, controlling deposits of $31.5 million, representing approximately 6.8 percent of market deposits. Union Planters operates the seventh largest depository institution in the market, controlling deposits of $23.6 million, representing approximately 5.1 percent of market deposits. After the proposed merger, New Regions would operate the third largest depository institution in the market, controlling deposits of $55.1 million, representing approximately 11.8 percent of market deposits. Six depository institutions would remain in the banking market. The HHI would increase by 69 points to 2505.

Corning, Arkansas

Regions operates the fourth largest depository institution in the market, controlling deposits of $21.4 million, representing approximately 10 percent of market deposits. Union Planters operates the fifth largest depository institution in the market, controlling deposits of $19.5 million, representing approximately 9.1 percent of market deposits. After the proposed merger, New Regions would operate the third largest depository institution in the market, controlling deposits of approximately $41 million, representing approximately 19 percent of market deposits. Six depository institutions would remain in the banking market. The HHI would increase by 180 points to 2343.

Fayetteville, Tennessee

Regions operates the second largest depository institution in the market, controlling deposits of $77.1 million, representing approximately 20.3 percent of market deposits. Union Planters operates the seventh largest depository institution in the market, controlling deposits of $18.6 million, representing approximately 4.9 percent of market deposits. After the proposed merger, New Regions would remain the second largest depository institution in the market, controlling deposits of approximately $95.6 million, representing approximately 25.2 percent of market deposits. Six depository institutions would remain in the banking market. The HHI would increase by 199 points to 1998.

Houston, Texas

Regions operates the 33rd largest depository institution in the market, controlling deposits of $196.7 million, representing less than 1 percent of market deposits. Union Planters operates the 20th largest depository institution in the market, controlling deposits of $494.2 million, representing less than 1 percent of market deposits. After the proposed merger, New Regions would operate the 13th largest depository institution in the market, controlling deposits of $690.9 million, representing less than 1 percent of market deposits. Eighty-three depository institutions would remain in the banking market. The HHI would not increase, remaining at 2641.

Memphis, Tennessee/Arkansas/Mississippi

Regions operates the 11th largest depository institution in the market, controlling deposits of $324.1 million, representing approximately 1.3 percent of market deposits. Union Planters operates the third largest depository institution in the market, controlling deposits of $3.7 billion, representing approximately 15.5 percent of market deposits. After the proposed merger, New Regions would operate the second largest depository institution in the market, controlling deposits of approximately $4.1 billion, representing approximately 16.8 percent of market deposits. Fifty-one depository institutions would remain in the banking market. The HHI would increase by 41 points to 2250.

Mobile, Alabama

Regions operates the largest depository institution in the market, controlling deposits of $2.2 billion, representing approximately 37.3 percent of market deposits. Union Planters operates the eighth largest depository institution in the market, controlling deposits of $120.1 million, rep-

resenting approximately 2.1 percent of market deposits. After the proposed merger, New Regions would remain the largest depository institution in the market, controlling deposits of approximately $2.3 billion, representing approximately 39.4 percent of market deposits. Seventeen depository institutions would remain in the banking market. The HHI would increase by 155 points to 2310.

Newport, Arkansas

Regions operates the fourth largest depository institution in the market, controlling deposits of $4.5 million, representing approximately 2.5 percent of market deposits. Union Planters operates the third largest depository institution in the market, controlling deposits of $37.4 million, representing approximately 20.9 percent of market deposits. After the proposed merger, New Regions would operate the second largest depository institution in the market, controlling deposits of approximately $42 million, representing approximately 23.4 percent of market deposits. Three depository institutions would remain in the banking market. The HHI would increase by 106 points to 3964.

Paragould, Arkansas

Regions operates the eighth largest depository institution in the market, controlling deposits of $17.4 million, representing approximately 3.1 percent of market deposits. Union Planters operates the fourth largest depository institution in the market, controlling deposits of $61.2 million, representing approximately 10.8 percent of market deposits. After the proposed merger, New Regions would operate the second largest depository institution in the market, controlling deposits of approximately $78.5 million, representing approximately 13.9 percent of market deposits. Eight depository institutions would remain in the banking market. The HHI would increase by 66 points to 2525.

ORDERS ISSUED UNDER INTERNATIONAL BANKING ACT

Hypothekenbank in Essen AG
Essen, Germany

Order Approving Establishment of a Representative Office

Hypothekenbank in Essen AG ("Bank"), Essen, Germany, 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 submit comments, has been published in a newspaper of general circulation in New York, New York (*The New York Times*, January 30, 2004). The time for filing comments has expired, and all comments have been considered.

Bank, with total consolidated assets of approximately $92 billion,[1] is the fifth largest mortgage bank in Germany and is primarily engaged in real estate mortgage lending and public sector lending. Bank operates representative offices in Belgium, France, and the United Kingdom.

Bank is owned by Commerzbank, AG, Frankfurt, Germany, and Helvetic Grundbesitz Verwaltung GmbH. Commerzbank, with consolidated total assets of approximately $493 billion, is the fourth largest banking organization in Germany.[2] Commerzbank engages in banking operations in the United States through branches in New York, New York; Chicago, Illinois; and Los Angeles, California; and an agency in Atlanta, Georgia. Commerzbank also engages in nonbanking activities in the United States through a number of subsidiaries.

The proposed representative office would initially act as a liaison with existing and potential customers of Bank. The office would also conduct research and may solicit commercial mortgage loans in the United States.

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 and has furnished to the Board the information it needs to assess the application adequately. The Board also shall take into account whether the foreign bank and any foreign bank parent is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor (12 U.S.C. §3107(a)(2); 12 CFR 211.24(d)(2)).[3] In addition, the Board may take into account additional standards set forth in the IBA and Regulation K (12 U.S.C. §3105(d)(3)–(4); 12 CFR 211.24(c)(2)).

As noted above, Bank and Commerzbank engage directly in the business of banking outside the United States. Bank also has provided the Board with information necessary to assess the application through submissions that address the relevant issues. With respect to supervision by home country authorities, the Board previously has

1. Unless otherwise indicated, data are as of December 31, 2003.
2. Data are as of March 31, 2004.
3. In assessing this standard, the Board considers, among other factors, the extent to which the home country supervisors:

(i) Ensure that the bank has adequate procedures for monitoring and controlling its activities worldwide;
(ii) Obtain information on the condition of the bank and its subsidiaries and offices through regular examination reports, audit reports, or otherwise;
(iii) Obtain information on the dealings with and relationship between the bank and its affiliates, both foreign and domestic;
(iv) Receive from the bank financial reports that are consolidated on a worldwide basis or comparable information that permits analysis of the bank's financial condition on a worldwide consolidated basis;
(v) Evaluate 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.

determined, in connection with applications involving other German banks, including Commerzbank, that those banks were subject to home country supervision on a consolidated basis.[4] Bank is supervised by the German Federal Financial Supervisory Agency on substantially the same terms and conditions as the other banks. Based on all the facts of record, it has been determined that Bank is and Commerzbank continues to be subject to comprehensive supervision and regulation on a consolidated basis by their home country supervisor.

The additional standards set forth in section 7 of the IBA and Regulation K (*see* 12 U.S.C. §3105(d)(3)–(4); 12 CFR 211.24(c)(2)) have also been taken into account. The German Federal Financial Supervisory Agency has no objection to the establishment of the proposed representative office.

With respect to the financial and managerial resources of Bank, taking into consideration Bank's record of operations in its home country, its overall financial resources, and its standing with its home country supervisor, financial and managerial factors are consistent with approval of the proposed representative office. Bank appears to have the experience and capacity to support the proposed representative office and has established controls and procedures for the proposed representative office to ensure compliance with U.S. law.

Germany is a member of the Financial Action Task Force and subscribes to its recommendations regarding measures to combat money laundering. In accordance with these recommendations, Germany has enacted laws and created legislative and regulatory standards to deter money laundering. Money laundering is a criminal offense in Germany and credit institutions are required to establish internal policies and procedures for its detection and prevention.

With respect to access to information on Bank's operations, the restrictions on disclosure in relevant jurisdictions in which Bank operates have been reviewed and relevant government authorities have been communicated with regarding access to information. Bank and its parents have committed to make available to the Board such information on the operations of Bank and any of their 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 by law or otherwise, Bank and its parents have committed to cooperate with the Board to obtain any necessary consents or waivers that might be required from third parties for disclosure of such information. In addition, subject to certain conditions, the German Federal Financial Supervisory Agency may share information on Bank's operations with other supervisors, including the Board. In light of these commitments and other facts of record, and subject to the condition described below, it has been determined that Bank has provided adequate assurances of access to any necessary information that the Board may request.

On the basis of all the facts of record, and subject to the commitments made by Bank and its parents, and the terms and conditions set forth in this order, Bank's application to establish the representative office is hereby approved.[5] Should any restrictions on access to information on the operations or activities of Bank or any of its affiliates subsequently interfere with the Board's ability to obtain information to determine and enforce compliance by Bank or its affiliates with applicable federal statutes, the Board may require or recommend termination of any of Bank's direct and indirect activities in the United States. Approval of this application also is specifically conditioned on compliance by Bank and its parent companies with the commitments made in connection with this application and with the conditions in this order.[6] 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 against Bank and its affiliates under 12 U.S.C. § 1818.

By order, approved pursuant to authority delegated by the Board, effective June 18, 2004.

ROBERT DEV. FRIERSON
Deputy Secretary of the Board

FINAL ENFORCEMENT DECISIONS ISSUED BY THE BOARD OF GOVERNORS

In the Matter of a Notice to Prohibit Further Participation Against

Garfield C. Brown, Jr.,
Former Employee,
Mellon Bank, N.A.
Pittsburgh, Pennsylvania

Docket No. OCC-AA-EC-03-11

Final Decision

This is an administrative proceeding pursuant to the Federal Deposit Insurance Act ("the FDI Act") in which the Office of the Comptroller of the Currency of the United States of America ("OCC") seeks to prohibit the Respon-

4. *See, e.g., HSH Nordbank AG,* 89 *Federal Reserve Bulletin* 344 (2003); *Eurohypo AG,* 88 *Federal Reserve Bulletin* 504 (2002); *Commerzbank AG,* 85 *Federal Reserve Bulletin* 336 (1999).

5. Approved by the Director of the Division of Banking Supervision and Regulation, with the concurrence of the Associate General Counsel, pursuant to authority delegated by the Board and the General Counsel.

6. 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 or its agent, the New York State Banking Department ("Department"), to license the proposed office of Bank in accordance with any terms or conditions that the Department may impose.

dent, Garfield C. Brown, Jr. ("Respondent"), from further participation in the affairs of any financial institution because of his conduct as an employee of Mellon Bank, N.A., Pittsburgh, Pennsylvania (the "Bank"), a national bank. Under the FDI Act, the OCC may initiate a prohibition proceeding against a former employee of a national bank, but the Board must make the final determination whether to issue an order of prohibition.

Upon review of the administrative record, the Board issues this Final Decision adopting the Recommended Decision of Administrative Law Judge Ann Z. Cook (the "ALJ"), and orders the issuance of the attached Order of Prohibition.

I. Statement of the Case

A. Statutory and Regulatory Framework

Under the FDI Act and the Board's regulations, the ALJ is responsible for conducting proceedings on a notice of charges. 12 U.S.C. § 1818(e)(4). The ALJ issues a recommended decision that is referred to the deciding agency together with any exceptions to those recommendations filed by the parties. The Board makes the final findings of fact, conclusions of law, and determination whether to issue an order of prohibition in the case of prohibition orders sought by the OCC. *Id.*; 12 CFR 263.40.

The FDI Act sets forth the substantive basis upon which a federal banking agency may issue against a bank official or employee an order of prohibition from further participation in banking. To issue such an order, the Board must make each of three findings: (1) that the respondent engaged in identified *misconduct*, including a violation of law or regulation, an unsafe or unsound practice or a breach of fiduciary duty; (2) that the conduct had a specified *effect*, including financial loss to the institution or gain to the respondent; and (3) that the respondent's conduct involved either personal dishonesty or a willful or continuing disregard for the safety or soundness of the institution. 12 U.S.C. § 1818(e)(1)(A)–(C).

An enforcement proceeding is initiated by filing and serving on the respondent a notice of intent to prohibit. Under the OCC's and the Board's regulations, the respondent must file an answer within 20 days of service of the notice. 12 CFR 19.19(a) and 263.19(a). Failure to file an answer constitutes a waiver of the respondent's right to contest the allegations in the notice, and a final order may be entered unless good cause is shown for failure to file a timely answer. 12 CFR 19.19(c)(1) and 263.19(c)(1).

B. Procedural History

On June 3, 2003, the OCC issued a Notice initiating an enforcement action that sought, *inter alia*, an order of prohibition against Respondent for his participation in processing three cash advances for an acquaintance, totaling $15,000, knowing that his acquaintance presented false identification to obtain the cash advances. The Notice further alleges that Respondent recorded inaccurate identification information on the cash advance slips completed for these transactions, and that the Respondent received $500 from his acquaintance for his participation in these cash advances.[1] The Notice directed Respondent to file an answer within 20 days, and warned that failure to do so would constitute a waiver of her right to appear and contest the allegations. The record shows that the Respondent received service of the Notice. Nonetheless, Respondent failed to file an answer within the 20-day period.

On or about July 24, 2003, Enforcement Counsel filed a Motion for Entry of an Order of Default. The motion was served on Respondent in accordance with the OCC's rules, but he did not respond to it. Finally, on or about July 29, 2003, Respondent received service of an Order to Show Cause directing him to submit an answer by August 13, 2003, and to demonstrate good cause for not having done so previously. That Order, too, was ignored. Respondent has never filed an answer to the Notice.

II. Discussion

The OCC's Rules of Practice and Procedure set forth the requirements of an answer and the consequences of a failure to file an answer to a Notice. Under the Rules, failure to file a timely answer "constitutes a waiver of [a respondent's] right to appear and contest the allegations in the Notice." 12 CFR 19.19(c). If the ALJ finds that no good cause has been shown for the failure to file, the judge "shall file . . . a recommended decision containing the findings and the relief sought in the notice." *Id.* An order based on a failure to file a timely answer is deemed to be issued by consent. *Id.*

In this case, Respondent failed to file an answer despite notice to him of the consequences of such failure, and also failed to respond to the ALJ's Order to Show Cause. Respondent's failure to file an answer constitutes a default.

Respondent's default requires the Board to consider the allegations in the Notice as uncontested. The Notice alleges, and the Board finds, that on or about July 30, 1998, Respondent processed for his acquaintance two cash advances against a credit card, each in the amount of $3,500, knowing that the driver's license presented by his acquaintance matched neither the name of the acquaintance, nor the name of the cardholder against which the cash advance was taken. Additionally, on or about August 5, 1998, Respondent processed for the same acquaintance another cash advance in the amount of $8,000 against a different credit card, after the acquaintance presented the same driver's license that was used for identification in the July 30, 1998 transactions. The Notice alleges and the Board finds that on both occasions, Respondent recorded inaccurate identification information on Bank records, at the request of his acquaintance, and that Respondent received $500 from his acquaintance for his participation in these cash advance transactions. The Bank

1. The Notice also sought an order requiring Respondent to make restitution to the Bank under 12 U.S.C. 1818(b)(6). The OCC has authority to issue a final decision with respect to this requested relief.

reimbursed the cardholders who were wrongfully charged, and thereby suffered a loss of $15,000.

This conduct by Respondent meets all the criteria for entry of an order of prohibition under 12 U.S.C. § 1818(e). It is a breach of fiduciary duty and an unsafe or unsound practice for a bank employee to give bank funds to a person the bank employee knows is not entitled to receive such funds, to accept identification documents that the bank employee knows does not belong to a customer requesting a bank transaction, and to record inaccurate information on bank records. Respondent's action caused gain to himself, as well as loss to the Bank. Finally, such actions, along with Respondent's acceptance of $500 for his involvement in this fraudulent scheme, also exhibit personal dishonesty. Accordingly, the requirements for an order of prohibition have been met and the Board hereby issues such an order.

Conclusion

For these reasons, the Board orders the issuance of the attached Order of Prohibition.

By order of the Board of Governors, this 21st day of November 2003.

Board of Governors of the
Federal Reserve System

JENNIFER J. JOHNSON
Secretary of the Board

Order of Prohibition

Whereas, pursuant to section 8(e) of the Federal Deposit Insurance Act, as amended, (the "FDI 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 GARFIELD C. BROWN, Jr. ("Brown"), a former employee and institution-affiliated party, as defined in Section 3(u) of the FDI Act (12 U.S.C. § 1813(u)), of Mellon Bank, N.A., Pittsburgh, Pennsylvania.

NOW, THEREFORE, IT IS HEREBY ORDERED, pursuant to section 8(e) of the FDI Act, 12 U.S.C. § 1818(e), 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)), Brown is hereby prohibited:
   (a) from participating in any manner in the conduct of the affairs of any institution or agency specified in section 8(e)(7)(A) of the FDI Act (12 U.S.C. § 1818(e)(7)(A)), including, but not limited to, any insured depository institution, any insured depository institution holding company or any U.S. branch or agency of a foreign banking organization;
   (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 FDI Act (12 U.S.C. § 1818(e)(7)(A));
   (c) from violating any voting agreement previously approved by any 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 FDI Act (12 U.S.C. § 1813(u)), such as an officer, director, or employee in any institution described in section 8(e)(7)(A) of the FDI Act (12 U.S.C. § 1818(e)(7)(A)).
2. Any violation of this order shall separately subject Brown to appropriate civil or criminal penalties or both under section 8 of the FDI Act (12 U.S.C. § 1818).
3. This order, and each and every 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 at the expiration of thirty days after service is made.

By order of the Board of Governors, this 21st day of November 2003.

Board of Governors of the
Federal Reserve System

JENNIFER J. JOHNSON
Secretary of the Board

In the Matter of a Notice to Prohibit Further Participation Against

Marian L. Butler,
Former Employee,
CoreStates Financial (now First Union)
Philadelphia, Pennsylvania

Docket No. OCC-AA-EC-02-07

Final Decision

This is an administrative proceeding pursuant to the Federal Deposit Insurance Act ("FDI Act") in which the Office of the Comptroller of the Currency of the United States of America ("OCC") seeks to prohibit the Respondent, Marian L. Butler ("Respondent"), from further participation in the affairs of any financial institution because of her conduct as an employee of CoreStates Financial (now First Union) (the "Bank"), a national banking association. Under the FDI Act, the OCC may initiate a prohibition proceeding against a former employee of a national

bank, but the Board must make the final determination whether to issue an order of prohibition.

Upon review of the administrative record, the Board issues this Final Decision adopting the Recommended Decision of Administrative Law Judge Ann Z. Cook (the "ALJ"), and orders the issuance of the attached Order of Prohibition.

I. Statement of the Case

A. Statutory and Regulatory Framework

Under the FDI Act and the Board's regulations, the ALJ is responsible for conducting proceedings on a notice of charges. 12 U.S.C. § 1818(e)(4). The ALJ issues a recommended decision that is referred to the deciding agency together with any exceptions to those recommendations filed by the parties. The Board makes the final findings of fact, conclusions of law, and determination whether to issue an order of prohibition in the case of prohibition orders sought by the OCC. *Id.*; 12 CFR § 263.40.

The FDI Act sets forth the substantive basis upon which a federal banking agency may issue against a bank official or employee an order of prohibition from further participation in banking. To issue such an order, the Board must make each of three findings: (1) that the respondent engaged in identified *misconduct*, including a violation of law or regulation, an unsafe or unsound practice or a breach of fiduciary duty; (2) that the conduct had a specified *effect*, including financial loss to the institution or gain to the respondent; and (3) that the respondent's conduct involved either personal dishonesty or a willful or continuing disregard for the safety or soundness of the institution. 12 U.S.C. § 1818(e)(1)(A)–(C).

An enforcement proceeding is initiated by filing and serving on the respondent a notice of intent to prohibit. Under the OCC's and the Board's regulations, the respondent must file an answer within 20 days of service of the notice. 12 CFR 19.19(a) and 263.19(a). Failure to file an answer constitutes a waiver of the respondent's right to contest the allegations in the notice, and a final order may be entered unless good cause is shown for failure to file a timely answer. 12 CFR 19.19(c)(1) and 263.19(c)(1).

B. Procedural History

On August 6, 2002, the OCC issued a Notice initiating an enforcement action that sought an order of prohibition due to Respondent's actions in stealing between $10,000 and $15,000 from the Bank while working in the cash processing unit. The Notice directed Respondent to file an answer within 20 days, and warned that failure to do so would constitute a waiver of her right to appear and contest the allegations. The record shows that the OCC made numerous efforts to serve the Notice on Respondent. The initial copy of the Notice was mailed certified mail, return receipt requested, on August 7, 2002, but the receipt was never returned. A second copy of the Notice was served on Respondent by overnight delivery on September 11, 2002. The courier service returned the package as "refused" by the addressee. A process server was dispatched to Respondent's address on September 21, 2002, but was told that there was no one by Respondent's name at that address. On October 1, 2002, Enforcement Counsel sent two more copies to Respondent's home address, one by certified mail, return receipt requested, and one by courier, this time not indicating that the package was from the OCC. Although no return receipt was returned for the copy sent by certified mail, an individual with Respondent's last name signed for the couriered copy on October 4, 2002.[1] Nonetheless, Respondent failed to file an answer within the 20-day period specified in that copy of the Notice. On November 27, 2002, the ALJ issued an Order to Show Cause directing Respondent to submit an answer by December 16, 2002, and demonstrate good cause for not having done so previously. The record reflects that the Order was delivered by courier to Respondent's address and signed for on December 2, 2002. Respondent did not respond to the Order to Show Cause and has never filed an answer to the Notice.

II. Discussion

The OCC's Rules of Practice and Procedure set forth the requirements of an answer and the consequences of a failure to file an answer to a Notice. Under the Rules, failure to file a timely answer "constitutes a waiver of [a respondent's] right to appear and contest the allegations in the Notice." 12 CFR 19.19(c). If the ALJ finds that no good cause has been shown for the failure to file, the judge "shall file . . . a recommended decision containing the findings and the relief sought in the notice." *Id.* An order based on a failure to file a timely answer is deemed to be issued by consent. *Id.*

The record establishes that the OCC used methods "reasonably calculated to give actual notice" in its efforts to notify Respondent of the pendency of this case. 12 CFR 19.11(c)(2)(v). Nonetheless, Respondent failed to file an answer despite notice to her of the consequences of such failure, and also failed to respond to the ALJ's Order to show cause. Respondent's failure to file an answer constitutes a default.

Respondent's default requires the Board to consider the allegations in the Notice as uncontested. The Notice alleges, and the Board finds, that Respondent stole between $10,000 and $15,000 in cash from the Bank while working as a temporary employee in the cash processing unit.[2] This conduct meets all the criteria for entry of an order of prohibition under 12 U.S.C. § 1818(e). It is a violation of

1. The person who signed for the package did not provide a first name.

2. Respondent was an employee of Manpower Temps, and was contracted from Manpower Temps to work at the Bank. The Board finds that this qualifies her as an institution-affiliated party within the meaning of 12 U.S.C § 1818(u)(1), in that she was an "employee . . . of, or agent for, an insured depository institution."

law and an unsafe or unsound practice for a bank employee to steal bank funds. Respondent's actions caused gain to herself as well as loss to the Bank. Finally, Respondent's actions involved personal dishonesty in taking property not her own. The requirements for an order of prohibition having been met, the Board has determined that such an order will issue.

Conclusion

For these reasons, the Board orders the issuance of the attached Order of Prohibition.

By order of the Board of Governors, this 13th day of February, 2003.

Board of Governors of the
Federal Reserve System

JENNIFER J. JOHNSON
Secretary of the Board

In the Matter of a Notice to Prohibit Further Participation Against

Stephanie Edmond,
Former Customer Service Representative and Teller
First Tennessee Bank, NA,
Memphis, Tennessee
and
Former Teller
Bank of America, NA,
Charlotte, North Carolina

Docket No. OCC-AA-EC-03-24

Final Decision

This is an administrative proceeding pursuant to the Federal Deposit Insurance Act ("FDI Act") in which the Office of the Comptroller of the Currency of the United States of America ("OCC") seeks to prohibit the Respondent, Stephanie Edmond ("Respondent"), from further participation in the affairs of any financial institution based on her conduct while she was employed at First Tennessee Bank, NA, Memphis, Tennessee ("First Tennessee"), as well as Bank of America, NA, Charlotte, North Carolina ("BoA"), both national banking associations. Under the FDI Act, the OCC may initiate a prohibition proceeding against a former employee of a national bank, but the Board must make the final determination whether to issue an order of prohibition.

Upon review of the administrative record, the Board issues this Final Decision adopting the Recommended Decision ("Recommended Decision") of Administrative Law Judge Arthur L. Shipe (the "ALJ"), and orders the issuance of the attached Order of Prohibition.

I. Statement of the Case

A. Statutory and Regulatory Framework

Under the FDI Act and the Board's regulations, the ALJ is responsible for conducting proceedings on a notice of charges. 12 U.S.C. § 1818(e)(4). The ALJ issues a recommended decision that is referred to the deciding agency together with any exceptions to those recommendations filed by the parties. The Board makes the final findings of fact, conclusions of law, and determination whether to issue an order of prohibition in the case of prohibition orders sought by the OCC. *Id.*; 12 CFR 263.40.

The FDI Act sets forth the substantive basis upon which a federal banking agency may issue against a bank official or employee an order of prohibition from further participation in banking. In order to issue such an order, the Board must make each of three findings: (1) that the respondent engaged in identified *misconduct*, including a violation of law or regulation, an unsafe or unsound practice, or a breach of fiduciary duty; (2) that the conduct had a specified *effect*, including financial loss to the institution or gain to the respondent; and (3) that the respondent's conduct involved either personal dishonesty or a willful or continuing disregard for the safety or soundness of the institution. 12 U.S.C. § 1818(e)(1)(A)–(C).

An enforcement proceeding is initiated by the filing of a notice of charges which is served on the respondent. Under the OCC's and the Board's regulations, the respondent must file an answer within 20 days of service of the notice. 12 CFR 19.19(a) and 263.19(a). Failure to file an answer constitutes a waiver of the respondent's right to contest the allegations in the notice, and a final order may be entered unless good cause is shown for failure to file a timely answer. 12 CFR 19.19(c)(1) and 263.19(c)(1).

B. Procedural History

On September 24, 2003, the OCC issued a Notice initiating an enforcement action that sought an order of prohibition against Respondent based on her actions while employed at two different banks. The Notice directed Respondent to file an answer within 20 days, and warned that failure to do so would constitute a waiver of her right to appear and contest the allegations. The OCC sent the Notice by overnight delivery to the two last known addresses for Respondent. On September 25, 2003, a "Ms. Edmond" signed for receipt of the Notice at one of these addresses. However, Respondent failed to file an answer within the 20-day period specified in the Notice.

On November 4, 2003, Enforcement Counsel for the OCC moved for entry of an order of default based on Respondent's failure to appear and file an answer. On November 24, 2003, the ALJ issued an Order to Show Cause, noting that Respondent had not replied to the OCC's motion, and directing Respondent to appear and demonstrate why the ALJ should not grant the default motion.

From approximately December 16, 2003, through the beginning of February 2004, a private process server hired by the OCC made nine attempts to personally serve Respondent with the Order to Show Cause at the address where the Notice had been sent and received. However, residents at this address refused to acknowledge the process server when he attempted service. The OCC confirmed in a January 2004 telephone conversation with Respondent's mother that Respondent resided at this address. The record reflects that the process server ultimately posted the Order at this address on February 11, 2004. Respondent did not respond to the Order to Show Cause and has never filed an answer to the Notice.

II. Discussion

The OCC's Rules of Practice and Procedure set forth the requirements of an answer and the consequences of a failure to file an answer to a Notice. Under the rules, failure to file a timely answer "constitutes a waiver of [a respondent's] right to appear and contest the allegations in the notice." 12 CFR 19.19(c). If the ALJ finds that no good cause has been shown for the failure to file, the judge "shall file . . . a recommended decision containing the findings and the relief sought in the notice." *Id.* An order based on a failure to timely answer is deemed to be issued by consent. *Id.*

The record establishes that at a minimum, the OCC used methods "reasonably calculated to give actual notice" in its efforts to notify Respondent of the pendency of this case. 12 CFR 19.11(c)(2)(v). The OCC identified two last known addresses for the Respondent. On September 25, 2003, a "Ms. Edmond" signed for receipt of the overnight delivery of the Notice at one of these addresses. By telephone conversation following receipt of the Notice, Respondent's mother, Mary Edmond, confirmed that the address to which the Notice had been sent was her address, and that her daughter, the Respondent, resided with her at that address. Finally, on February 11, 2004, a process server delivered the Order to Show Cause to this same address. Nonetheless, Respondent failed to file an answer despite notice to her of the consequences of such failure, and also failed to respond to the ALJ's Order to Show Cause. Respondent's failure to file an answer constitutes a default.

Respondent's default requires the Board to consider the allegations in the Notice as uncontested. The Notice alleges, and the Board finds, that while employed at First Tennessee, Respondent fraudulently benefited from a First Tennessee installment loan by, among other things, providing false information on loan documents and forging the name and signature of a cosigner. Respondent's fraudulent loan subsequently went into default. Also while employed at First Tennessee, Respondent took out a loan in the name of a First Tennessee customer, without the customer's knowledge or consent, and by forging the customer's signature on the loan application. Respondent used the proceeds of this loan for her own benefit. Furthermore, while employed at BoA, Respondent executed a cash-out ticket without posting a corresponding ticket. This conduct meets the criteria for entry of an order of prohibition under 12 U.S.C. § 1818(e). It is a violation of law, a breach of fiduciary duty, and an unsafe or unsound practice for a bank employee to fraudulently obtain and benefit from loans issued by a bank at which she is employed. Moreover, it is an unsafe or unsound practice for a bank employee to fail to maintain proper record-keeping of the transactions she executes. Respondent's actions caused gain to herself, as well as a total loss of $22,346 to these two banks. Finally, Respondent's acts involved both personal dishonesty and a willful disregard for the safety or soundness of the banks at which she was employed.

In sum, all the elements necessary for the issuance of a prohibition order are presented in this case.

Conclusion

For these reasons, the Board orders the issuance of the attached Order of Prohibition.

By order of the Board of Governors, this 17th day of June 2004.

Board of Governors of the
Federal Reserve System

JENNIFER J. JOHNSON
Secretary of the Board

Order of Prohibition

Whereas, pursuant to section 8(e) of the Federal Deposit Insurance Act, as amended, (the "FDI 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 STEPHANIE EDMOND ("Edmond"), a former employee and institution-affiliated party, as defined in Section 3(u) of the FDI Act (12 U.S.C § 1813(u)), of First Tennessee Bank, NA, Memphis, Tennessee, and Bank of America, NA, Charlotte, North Carolina.

NOW, THEREFORE, IT IS HEREBY ORDERED, pursuant to section 8(e) of the FDI Act, 12 U.S.C. § 1818(e), 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)), Edmond is hereby prohibited:

(a) from participating in any manner in the conduct of the affairs of any institution or agency specified in section 8(e)(7)(A) of the FDI Act (12 U.S.C. § 1818(e)(7)(A)), including, but not limited to, any

insured depository institution, any insured depository institution holding company or any U.S. branch or agency of a foreign banking organization;
(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 FDI Act (12 U.S.C. § 1818(e)(7)(A));
(c) from violating any voting agreement previously approved by any 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 FDI Act (12 U.S.C. § 1813(u)), such as an officer, director, or employee in any institution described in section 8(e)(7)(A) of the FDI Act (12 U.S.C. § 1818(e)(7)(A)).

2. Any violation of this Order shall separately subject Edmond to appropriate civil or criminal penalties or both under section 8 of the FDI Act (12 U.S.C. § 1818).
3. This Order, and each and every 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 at the expiration of thirty days after service is made.

By order of the Board of Governors, this 17th day of June 2004.

Board of Governors of the
Federal Reserve System

JENNIFER J. JOHNSON
Secretary of the Board

In the Matter of a Notice to Prohibit Further Participation Against

Cynthia Rowe,
Former Employee,
Key Bank, N.A.,
Cleveland, Ohio

Docket No. OCC-AA-EC-02-13

Final Decision

This is an administrative proceeding pursuant to the Federal Deposit Insurance Act ("FDI Act") in which the Office of the Comptroller of the Currency of the United States of America ("OCC") seeks to prohibit the Respondent, Cynthia Rowe ("Respondent"), from further participation in the affairs of any financial institution because of her conduct as an employee of Key Bank, N.A., Cleveland, Ohio (the "Bank"). Under the FDI Act, the OCC may initiate a prohibition proceeding against a former employee of a national bank, but the Board must make the final determination whether to issue an order of prohibition.

Upon review of the administrative record, the Board issues this Final Decision adopting the Recommended Decision of Administrative Law Judge Ann Z. Cook (the "ALJ"), and orders the issuance of the attached Order of Prohibition.

I. Statement of the Case

A. Statutory and Regulatory Framework

Under the FDI Act and the Board's regulations, the ALJ is responsible for conducting proceedings on a notice of charges. 12 U.S.C. § 1818(e)(4). The ALJ issues a recommended decision that is referred to the deciding agency together with any exceptions to those recommendations filed by the parties. The Board makes the final findings of fact, conclusions of law, and determination whether to issue an order of prohibition in the case of prohibition orders sought by the OCC. *Id.*; 12 CFR 263.40.

The FDI Act sets forth the substantive basis upon which a federal banking agency may issue against a bank official or employee an order of prohibition from further participation in banking. To issue such an order, the Board must make each of three findings: (1) that the respondent engaged in identified *misconduct*, including a violation of law or regulation, an unsafe or unsound practice or a breach of fiduciary duty; (2) that the conduct had a specified *effect*, including financial loss to the institution or gain to the respondent; and (3) that the respondent's conduct involved either personal dishonesty or a willful or continuing disregard for the safety or soundness of the institution. 12 U.S.C.§ 1818(e)(1)(A)–(C).

An enforcement proceeding is initiated by filing and serving on the respondent a notice of intent to prohibit. Under the OCC's and the Board's regulations, the respondent must file an answer within 20 days of service of the notice. 12 CFR 19.19(a) and 263.19(a). Failure to file an answer constitutes a waiver of the respondent's right to contest the allegations in the notice, and a final order may be entered unless good cause is shown for failure to file a timely answer. 12 CFR 19.19(c)(1) and 263.19(c)(1).

B. Procedural History

On October 3, 2002, the OCC issued a Notice initiating an enforcement action that sought, inter alia, an order of prohibition due to Respondent's actions in stealing over $40,000 from the Bank over a three-year period.[1] The Notice directed Respondent to file an answer within 20 days, and warned that failure to do so would constitute a waiver of her right to appear and contest the allegations.

1. The Notice also sought an order requiring Respondent to make restitution to the Bank under 12 U.S.C. § 1818(b)(6)(A). The OCC has statutory authority to issue a final decision with respect to this requested relief.

The record shows that the Respondent acknowledged receipt of the Notice. Nonetheless, Respondent failed to file an answer within the 20-day period. A second copy of the Notice was served on October 25, 2002, and received by Respondent on October 30, 2002. The ALJ served an Order Setting Telephone Conference on November 13, 2002, which was received at Respondent's residence on November 14, 2002. Respondent did not, however, participate in the telephone conference call established by the Order. On November 21, 2002, Respondent was served with Enforcement Counsel's Motion for Entry of an Order of Default, but did not respond to it. On November 25, 2002, Respondent received service of an Order to Show Cause directing her to submit an answer by December 10, 2002, and demonstrate good cause for not having done so previously. That Order, too, was ignored. Respondent has never filed an answer to the Notice.

II. Discussion

The OCC's Rules of Practice and Procedure set forth the requirements of an answer and the consequences of a failure to file an answer to a Notice. Under the Rules, failure to file a timely answer "constitutes a waiver of [a respondent's] right to appear and contest the allegations in the Notice." 12 CFR 19.19(c). If the ALJ finds that no good cause has been shown for the failure to file, the judge "shall file . . . a recommended decision containing the findings and the relief sought in the notice." *Id.* An order based on a failure to file a timely answer is deemed to be issued by consent. *Id.*

In this case, Respondent failed to file an answer despite notice to her of the consequences of such failure, and also failed to respond to the ALJ's Order to show cause. Respondent's failure to file an answer constitutes a default.

Respondent's default requires the Board to consider the allegations in the Notice as uncontested. The Notice alleges, and the Board finds, that Respondent repeatedly stole cash from the Bank's teller drawers over a three-year period. She also made fraudulent entries in the Bank's books and records to reverse overdrafts to her account at the Bank. Together, these thefts totaled over $40,000.

This conduct meets all the criteria for entry of an order of prohibition under 12 U.S.C. § 1818(e). It is a violation of law and an unsafe or unsound practice for a bank employee to steal bank funds and to falsify bank records. Respondent's actions caused gain to herself as well as loss to the Bank. Finally, Respondent's actions involved personal dishonesty in taking property not her own. The requirements for an order of prohibition having been met, the Board has determined that such an order will issue.

Conclusion

For these reasons, the Board orders the issuance of the attached Order of Prohibition.

By order of the Board of Governors, this 13th day of February, 2003.

Board of Governors of the
Federal Reserve System

JENNIFER J. JOHNSON
Secretary of the Board

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 CYNTHIA ROWE ("Rowe"), a former employee and institution-affiliated party, as defined in Section 3(u) of the Act (12 U.S.C § 1813(u)), of Key Bank, N.A., Cleveland, Ohio.

NOW, THEREFORE, IT IS HEREBY ORDERED, pursuant to section 8(e) of the Act, 12 U.S.C. § 1818(e), 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)), Rowe is 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 any 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.

Conclusion

This order shall become effective at the expiration of thirty days after service is made.

By order of the Board of Governors, this 13th day of February, 2003.

Board of Governors of the
Federal Reserve System

JENNIFER J. JOHNSON
Secretary of the Board

In the Matter of a Notice to Prohibit Further Participation Against

Gene Ulrich,
Former Senior Vice President and
Senior Loan Officer,
and
Susan Diehl McCarthy,
Former Vice President and Loan Officer
Six Rivers National Bank,
Eureka, California

Docket No. AA-EC-00-40

Final Decision

This is an administrative proceeding brought pursuant to the Federal Deposit Insurance Act (FDI Act) in which the Office of the Comptroller of the Currency ("OCC") seeks to prohibit the Respondents Gene Ulrich ("Ulrich") and Susan Diehl McCarthy ("Diehl McCarthy") from further participation in the affairs of any financial institution because of their respective conduct as officers at the Six Rivers National Bank, Eureka, California (the Bank). Respondent Ulrich served as Senior Vice President and Senior Loan Officer at the Bank, and Respondent Diehl McCarthy held the positions of Vice President and Loan Officer. As required by statute, the OCC has referred the action to the Board of Governors of the Federal Reserve System (the "Board") for final action.

Upon review of the administrative record, the Board issues this Final Decision adopting the Recommended Decision ("Recommended Decision") of Administrative Law Judge Ann Z. Cook (the "ALJ") except as specifically supplemented or modified herein. The Board therefore orders that the attached Orders of Prohibition issued 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*—Under the FDI Act and the Board's regulations, the ALJ is responsible for conducting an administrative hearing on a notice of intent to prohibit participation. 12 U.S.C. § 1818(e)(4). Following the hearing, the ALJ issues a recommended decision that is referred to the deciding agency together with any exceptions to those recommendations filed by the parties. The Board makes the final findings of fact, conclusions of law and determination whether to issue an order of prohibition in the case of a prohibition order sought by the OCC. *Id.*; 12 CFR 263.40.

The FDI Act sets forth the substantive basis upon which a federal banking agency may issue against a bank official an order of prohibition from further participation in banking. In order to issue such an order pursuant to section 1818(e)(1), the Board must make each of three findings: (1) that the respondent engaged in identified *misconduct*, including a violation of law or regulation, an unsafe or unsound practice, or a breach of fiduciary duty; (2) that the conduct had a specified *effect*, including financial loss to the institution or gain to the respondent; and (3) that the respondents conduct involved *culpability* of a certain degree—either personal dishonesty or a willful or continuing disregard for the safety or soundness of the institution. 12 U.S.C. § 1818(e)(1)(A)–(C).

2. *Statutory and Regulatory Lending Restrictions*—Section 84 of the National Bank Act (12 U.S.C. § 84) imposes limits on the degree to which national banks may concentrate credit to particular borrowers. In general, the total loans and other extensions of credit to a single borrower may not exceed 15 percent of a national bank's unimpaired capital and surplus. Under the OCC's regulations, loans to one borrower will be attributed to a second borrower when the proceeds of the loan are used for the "direct benefit" of the second person. 12 CFR 32.5(a)(1). Proceeds are deemed to be for the "direct benefit" of another person when the proceeds are "transferred to [the other] person," except in the case of a "bona fide arm's length transaction where the proceeds are used to acquire property, goods, or services." 12 CFR 32.5(b).

B. Procedural History

On October 12, 2000, the OCC issued a combined Notice of Intention to Prohibit Further Participation, a Notice of Charges for Restitution and a Notice of Assessment of Civil Money Penalty (together, the "Notices") against Ulrich and Diehl McCarthy. The Notices alleged that Ulrich and Diehl McCarthy violated law and regulation, recklessly engaged in unsafe or unsound practices and breached their fiduciary duties in connection with five loans they approved in December 1996. The Notices further alleged that Ulrich and Diehl McCarthy's misconduct resulted in a substantial monetary loss to the Bank and demonstrated personal dishonesty and a willful or continuing disregard for the safety or soundness of the Bank.

Following 18 days of hearings and post-hearing briefing, the ALJ issued a Recommended Decision in this matter, to which Respondents filed lengthy exceptions. The OCC did not file any exceptions. In her Recommended Decision, the ALJ concluded that the facts in this case warranted the imposition of an order of prohibition, restitution and second tier civil monetary penalties.

The case was then referred to the Board for review of the recommendation for prohibition, and to the OCC for review of the recommendations for restitution and civil monetary penalties. On September 2, 2003, the Comptroller issued a Decision and Order upholding the recommended restitution and imposing civil monetary penalties of $35,000 and $20,000, respectively, on Respondents Ulrich and Diehl McCarthy.

II. Discussion

The Board has reviewed the record in this matter to assure that substantial evidence in the record supports the factual and legal conclusions of the ALJ and warrants the imposition of a prohibition order against Respondents. The Board finds that the allegations contained in the OCC's Notices and proved at the hearing meet the statutory criteria for the issuance of an order of prohibition and adopts the Recommended Decision of the ALJ except as specifically modified or supplemented herein.

A. Facts

1. *Ulrich and Diehl McCarthy's Positions at the Bank*— Respondents Ulrich and Diehl McCarthy started working at the Bank around 1993 and 1994, respectively. (ALJ's Findings of Fact at ¶¶2, 7) (hereinafter "FF at ¶__"). Prior to coming to the Bank, each Respondent had obtained a significant amount of experience working in the banking industry, including holding positions of considerable responsibility. (FF at ¶¶3–5, 8).

In December 1996, and at all other times relevant for the purposes of this Final Decision, Respondent Ulrich served as Senior Vice President and Senior Loan Officer at the Bank, and Respondent Diehl McCarthy held the positions of Vice President, Government Guaranteed Loan Manager, and Loan Officer at the Bank. (FF at ¶¶1, 6). As a senior officer of the Bank, Ulrich was responsible for ensuring that loans issued by the Bank complied with the Bank's policy, as well as recommending or making revisions to the policy. (FF at ¶67). As an officer of the Bank, Diehl McCarthy also was responsible for ensuring that loans extended by the Bank complied with the Bank's policy. (FF at ¶68).

2. *NCH and Straightline's Lending From the Bank*— Northcoast Hardwoods, Inc. ("NCH") and Straightline Investments, Inc. ("Straightline") were two local companies to which the Bank extended loans before and during 1996. (FF at ¶11). NCH and Straightline were owned and operated by the same individual, Matthew Galt ("Galt"). (FF at ¶¶9, 10). The two companies operated for all practical purposes as two units of the same business. NCH served as the operating and sales unit, while Straightline functioned as the holding company that owned the real property and equipment. (FF at ¶10). For these reasons, NCH and Straightline were considered a single borrower for lending limit purposes. (FF at ¶10).

As of early December 1996, the Bank had approved and issued loans to NCH and Straightline totaling at least $928,159. (FF at ¶62). The Bank's legal lending limit, in effect during December 1–30, 1996, was $985,322. (FF at ¶63). *See* 12 U.S.C. §84, 12 CFR Part 32.

3. *Respondents' Knowledge of NCH's History of Loans from the Bank and of NCH's Financial Condition*—As of early December 1996, Respondents understood that NCH/Straightline had almost reached the maximum lending limit for a single borrower. (FF at ¶¶17, 29). In addition, Respondents knew that up to and around early December 1996, NCH consistently asked the Bank for additional loans, but simultaneously failed to meet its existing obligations to the Bank. Between February and December 1996, NCH requested and Respondents approved four loans to the company. In July and December 1996, NCH requested and Respondents approved extensions to NCH on existing loans for which payments were either "slow" or "past due" and in October 1996, NCH requested and Respondents approved a restructuring of NCH's existing debt. (FF at ¶11–12).

Finally, Respondents were familiar with the financial crisis NCH confronted by early December 1996. Respondents received letters in early December 1996 from Matthew Galt stating that NCH's net worth was negative $600,000, that the company had no money to pay for the supply and production costs of its outstanding customer orders, and that the company laid off almost 25 percent of its employees in November 1996. (FF at ¶13; OCC Exh. 51).

4. *NCH Searches For Help: Application for a Guaranteed Loan Through USDA*—Due to the financial difficulties NCH experienced in 1996, the company, with the help of both Respondents, sought additional means to obtain funds needed to maintain its operations. (FF at ¶¶18–31). Respondents worked with Galt to apply for a United States Department of Agriculture loan guarantee. (FF at ¶¶21–31). Loans guaranteed by a Federal agency do not count in the calculation of loans to a particular borrower, so the Bank could have made such a loan to NCH if the guarantee could be obtained. 12 CFR 32.2(c)(4). As Respondents assisted Galt in the application process, they were well aware of NCH's troubled credit and of the extreme difficulties NCH would encounter in attempting to raise capital for the company without first receiving a conditional commitment from the USDA for the guaranteed loan. (FF at ¶¶23, 26).

By letter dated December 9, 1996, the USDA declared it was unwilling to issue a conditional commitment to NCH for a guaranteed loan because of NCH's unproven products and markets, as well as the company's negative net worth of $600,000. (FF at ¶27). The letter stated if NCH was able to raise the company's tangible balance sheet equity to 10 percent, the USDA would consider issuing a conditional commitment subject to NCH being able to increase the company's tangible balance sheet equity to 20 percent. (FF at ¶27). However, the letter concluded by reiterating

concerns about NCH's financial stability and warning that the USDA made no guaranty to approve a conditional commitment or guaranteed loan even if NCH increased the company's tangible balance sheet equity. (FF at ¶27).

After receiving the December 9th letter from the USDA, Respondents met with Galt to discuss how NCH could raise 10 percent equity, which equated to $970,000. (FF at ¶¶28, 31). The three of them spoke about the possibility of third parties injecting capital into NCH, including the possibility that the Bank could issue loans to third parties who would inject the proceeds into NCH. (FF at ¶30). At that meeting, Ulrich told Galt that the Bank could not make any further loans to NCH. (FF at ¶29).

5. *The Five December 1996 Loans From The Bank*—Within days of the conversation about obtaining funds to inject into NCH, Respondents approved five loans, totaling $900,000, to friends and business associates of Galt (hereinafter, collectively, "the December 1996 loans"). (FF at ¶¶32, 34). On December 16, 1996, Respondents approved a $200,000 loan to Timothy and Paula Crowley and a $200,000 loan to Frank and Virginia Nemetz; on December 18, 1996, Respondents approved a $200,000 loan to Gary Johnston; and on December 30, 1996, Respondents approved a $200,000 loan to Mitchell and Maggie Tonini and a $100,000 loan to Valerie Weyna. Within a day or two of disbursement, the proceeds of each of the December 1996 loans were transferred to NCH. (FF at ¶¶38, 42, 49, 53–56, 60).[1] The aggregate amount of these loans, $900,000, equaled substantially all of the additional equity needed by NCH to enable USDA to consider a conditional commitment.

Respondents drafted and signed credit memoranda to accompany the Crowley, Nemetz and Johnston loans. These credit memoranda stated that each loan would initially "be booked by NCH as a loan," and would "convert to equity" upon approval of the USDA, or, in any event, "even if the [USDA] loan is not approved." (FF at ¶¶36, 40, 47; OCC Ex. 56, 58, 60). Other documents created and/or reviewed by Respondents in connection with all five transactions also indicated that all five loans would be re-loaned to NCH. (FF at ¶52; OCC Ex. 57, 76).

The loan approval process for the December 1996 loans did not start until after the meeting Respondents had with Galt on December 10, 1996. (FF at ¶¶28–32). Respondents allowed Galt to both contact and obtain information from the five borrowers in connection with the loans, and with one exception, Respondents communicated with the borrowers only through Galt. (FF at ¶79).[2] The loans violated the Bank's lending policy, which entirely prohibited loans for "speculative investments in securities," and also prohibited "capital loans for a start-up business" in the absence of a government loan guarantee. (FF at ¶¶69–70; OCC Exh. 140). Bank policy also provided that personal loans exceeding $20,000 required adequate collateral. (OCC Exh. 140 at 269). Respondents wrote up the December 1996 loans not as personal loans but as commercial "term capital loans," a category intended to provide working capital through a direct loan to an established company. (OCC Exh. 56, 58, 60, 63, 67; OCC Exh. 140 at 23–25; Trans. 94 (Tornborg)). Under the Bank's loan policy, even this type of loans could be issued on an unsecured basis only "extremely rarely, depending on debt coverage." *Id.* Yet all five of the December 1996 loans were unsecured; in none was any exception to the loan policy identified in the credit memoranda generated by Respondents. OCC Exhs. 56, 58, 60, 63, 67.

The loans were structured two-year, interest-only loans, with a balloon payment of all principal due at the end of the two-year term. OCC Exhs. 144–148. Despite the substantial amount and the short term of the loans, however, Respondents never spoke to any of the borrowers or made any efforts to identify a source of funds for repayment of the loans. In the minimal efforts they made to assess the financial condition of the borrowers, Respondents failed to obtain information necessary to make realistic credit assessments, included information that was outdated and/or not indicative of the borrowers' ability to repay the loans in accordance with their terms, and excluded critical factors such as the borrowers' living expenses. (*See, e.g.,* Trans. 3112–13, 3158 (Diehl McCarthy); Trans. 3370–71, 3373–74, 3377–78, 3384–85, 3388–90, 3392–93 (Matt Johnson); OCC Exhs. 215, 199). This was particularly critical in the case of several borrowers, who had limited cash flow and whose net worths were tied up in personal businesses or real estate. (OCC Exh. 63, 67). Assuming, as Respondents claim to have done, that the loan proceeds would be used to acquire stock in NCH, it is difficult to understand how that investment, in a closely-held private company, could serve as a source of repayment of the principal of these loans; in any event, there is no evidence that this question was ever considered by the Respondents.[3]

As Respondents acknowledge, the December 1996 Loans caused the Bank to violate its lending limits. Under the OCC's rules, loans to one borrower are attributed to another if the proceeds of the loan are transferred to the other, unless the transfer involved a "bona fide arm's length transaction where the proceeds are used to acquire property, goods, or services." 12 CFR 32.5(b). Here, there was no such arm's length transaction, and the loans were properly combined with those to NCH, causing the lending limits violation.

6. *Loss to the Bank*—Ultimately, none of the borrowers ever received any value in return for the $900,000 they

1. The disbursements to NCH were made despite Respondents' representations to the Bank's loan committee that $500,000 of the proceeds would be held in a "bank controlled account." (OCC Ex. 57). The account was never established. (Trans. 2635 (Ulrich)).

2. Diehl McCarthy spoke briefly with borrower Weyna at the time the loan documents were signed. (FF at ¶80).

3. Diehl McCarthy suggested that her obligation to identify a source of repayment was satisfied by suggesting to borrower Weyna that if the investment did not work out as hoped, the loan could be restructured when principal payment became due. (Trans. 3123–24 (Diehl McCarthy)). This is obviously insufficient as a means of identifying a source of repayment, even a restructured loan eventually involves the repayment of principal.

collectively gave to NCH, the USDA never issued a loan guarantee to NCH, NCH filed for bankruptcy, and the Bank was unable to collect on four of the five December loans. (FF at ¶¶61, 92, 94, 95). The Bank's board of directors bought two of the loans, and settlement and restitution paid by some of the borrowers and several members of the Bank's loan committee provided some additional recovery. However, the Bank currently maintains a loss of $232,000. (FF at ¶¶95–99).

B. Legal Conclusions

1. *Prohibition*—The sole purpose of this Final Decision and Order is to review the ALJ's recommendation for an order of prohibition against Respondents, as the ALJ's recommendation for an order of restitution and civil monetary penalties is reviewed by the OCC. To adopt the ALJ's conclusion regarding the prohibition, the Board must find that three elements have been met: (1) misconduct, including violation of law or regulation or participation in an unsafe or unsound practice, (2) a specified effect, including financial loss to the institution, and (3) culpability. 12 U.S.C. § 1818(e)(1)(A)–(C). Because the evidence in the record supports that all three elements have been met, the Board adopts the ALJ's recommendation for an order of prohibition against Respondents.

(a) *Misconduct and Specified Effect*—Respondents concede that they participated in a lending limits violation and that the Bank suffered a loss of $232,000 as a result. (Respondents' Exceptions at pp. 25, 34). These admissions, along with the record evidence that supports them, establish the first and second elements needed for an order of prohibition.

The ALJ also found, and the evidence supports, that Respondents engaged or participated in unsafe or unsound practices even apart from their participation in the lending limits violation.[4] As detailed above, in a number of critical respects, the December 1996 loans and the process by which they were approved contravened Bank policies designed to assure safety and soundness. If considered as loans to purchase stock in NCH, as Respondents contend, the loans violated the Bank's loan policies prohibiting loans for speculative investments in securities. If considered as capital loans, the loans violated the policy against capital loans to start-up businesses in the absence of an agency guarantee. If considered as personal loans to the borrowers, the loans violated the policy requiring collateral for such loans above $20,000. Even accepting the loan category in which Respondents placed these loans in their credit memoranda—commercial "term loans for capital," a category clearly not intended for loans of this type—such loans too required collateral and could be issued on an unsecured basis only "extremely rarely, depending on debt cover." (OCC Exh. 140 at 24).[5] Nonetheless, all of the December 1996 loans were approved on an unsecured basis, and the credit memoranda failed even to note, much less explain, the departure from the lending policy. The Bank's loan policy was established to limit the bank's exposure to risk; such violations of the loan policy clearly constituted unsafe or unsound practices.

As discussed earlier, the process by which the loans were granted also constituted an unsafe or unsound practice. Respondents rushed to approve the loans on the basis of incomplete or outdated information in violation of the loan policy, and left it to Galt, whom they knew to be desperately in need of funds, to communicate with the borrowers. They thereby opened themselves, and the Bank, up to be "victimized" by Galt's scheme to the extent they did not actively endorse it.[6] Respondents also failed to identify a source of repayment for the loans despite the obvious risk that such action entailed in the case of these large balloon loans made to borrowers whose cash flow did not appear sufficient to repay principal.

(b) *Culpability*—The only element in dispute in the case at hand is whether the record supports the ALJ's finding that Respondents' misconduct involved the requisite culpability. In a case involving a prohibition order under the FDI Act, culpability is established by showing that a respondent's misconduct involved either personal dishonesty or a willful or continuing disregard for the safety or soundness of the institution. 12 U.S.C. § 1818(e)(1)(C)(i)–(ii). Whatever the precise basis of culpability, the agency must prove that the respondent's misconduct exhibited a "degree of culpability beyond mere negligence." *Kim v. Office of Thrift Supervision*, 40 F.3d 1050, 1054 (9th Cir. 1994).

Acts of personal dishonesty have been described as those "involving fraud or lack of integrity." *Van Dyke v. Board of Governors of the Federal Reserve System*, 876 F.2d 1377, 1379 (8th Cir. 1989). Continuing disregard is considered to be conduct which has been "voluntarily engaged in over a period of time with heedless indifference to the prospective consequences." *Grubb v. FDIC*, 34 F.3d 956, 962 (10th Cir. 1994). Willful disregard has been defined as "deliberate conduct which exposed the bank to abnormal risk of loss or harm contrary to prudent banking practices." *Grubb*, 34 F.3d at 961–62; *Van Dyke*, 876 F.2d at 1380. For example, in *Cavallari v. Office of the Comptroller of the Currency*, 57 F.3d 137, 145 (2d Cir. 1995), the court upheld a pro-

4. Respondents' procedural argument that any evidence relating to unsafe and unsound practices should not have been admitted is discussed below.

5. According to the loan policy, term loans for capital were to be "used for established companies," with an emphasis on those with a "good [credit] history" with the Bank—a category of company that clearly excluded NCH. (OCC Exh. 140 at 24).

6. The risk associated with this practice is evidenced by the fact that Respondents claim to have been unaware that the borrowers had no intention of investing the proceeds of the loans in NCH, and expected Galt to repay the loans for them. Had they discussed the loans with the borrowers, they presumably would have learned of Galt's scheme before approving the loans.

hibition order where the Board found that the respondent's misconduct evidenced an "utter lack of attention to an institution's safety and soundness" or a "willingness to turn a blind eye to [the bank's] interests in the face of a known risk."

While all three types of culpability can be present in a given case, only one type is needed to support an order of prohibition. Here, the Board finds that Respondents' misconduct involved at least willful disregard for the safety and soundness of the Bank, and therefore does not reach the other bases of culpability.

Substantial evidence in the record supports a finding that Respondents' actions went beyond negligence and amounted to "willful disregard" of the Bank's safety and soundness. As noted above, Respondents approved $900,000 in loans in a matter of days, on the basis of information provided solely by a source with an obvious conflict of interest. Respondents knew that the proceeds of the loans would be transferred to NCH. As experienced bankers, they should have known that the loans were therefore attributable to NCH for lending limits purposes and would cause the Bank to violate its lending limits.

Prior to approving the loans, Respondents failed to determine whether the borrowers would be able to repay the loans based on their personal cash flow, and apparently considered the possibility that the Bank would renegotiate the loans at the conclusion of their two-year term to be sufficient for purposes of assuring repayment. Moreover, regardless of whether the five December loans are classified as commercial "term working capital loans," or as Respondents are more appropriately calling them now, "loans to individuals" (*see* Respondents' Exceptions at p. 27), Respondents ignored the risk they posed to the Bank by approving them on an unsecured basis. Several provisions of the Bank's loan policy established that the loans were of a type that posed an unacceptable risk to the Bank. To the extent Bank policy permitted loans of this type to be made at all, the policy required that they be adequately collateralized. Adequate collateral obviously would have assisted the Bank in avoiding the losses it suffered in connection with the loans. By approving these loans on an unsecured basis, Respondents not only violated Bank policy, but they "turn[ed] a blind eye to [the bank's] interests in the face of a known risk." *Cavallari*, 57 F.3d at 145.

These and other actions on the part of Respondents reveal their "utter lack of attention" to the safety and soundness of the Bank in connection with the December 1996 loans. *Cavallari*, 57 F.3d at 145. For example, the record reveals that Respondents were expressly asked by another bank officer whether two of these loans would be combinable with the NCH loans for lending limit purposes. Without any inquiry or research, Respondent Ulrich simply asserted they were not combinable, and Diehl McCarthy followed suit. (Trans. 2688–89 (Ulrich); Trans. 3160–61 (Diehl McCarthy)). This complete lack of concern about compliance with regulations designed to safeguard the Bank is further evidence of Respondents' "utter lack of attention" for the safety and soundness of the Bank.

The Board rejects Respondents' argument that they lacked the requisite culpability because they believed that the borrowers would use the loan proceeds to purchase stock and, as such, that they would not be combinable with NCH's loans for lending limits purposes. First, regardless of whether Respondents truly believed that the loans would eventually be converted to stock, they cannot claim that the loans would be used to purchase NCH stock upon disbursement.[7] Their own contemporaneous credit memoranda explicitly state that each of the five December loans would be "booked by NCH as a loan" from the borrower and only later "converted to equity" upon approval of the USDA loan guarantee "or even if the loan is not approved." (OCC Exhs. 56, 58, 60). Given the Respondents' knowledge of the highly uncertain nature and timing of the USDA approval, it is evident that Respondents had no expectation when they approved the loans that conversion to equity was imminent.

Moreover, even if the December 1996 loans had been for the purpose of funding the borrowers' purchase of shares in NCH immediately, the loans still would have been considered a "direct benefit" to NCH and therefore would still have resulted in violations of the Bank's lending limit. *See* 12 CFR 32.5(a)(1), (b); OCC Interpretive Letter, January 29, 1987 (1987 WL 149851) (OCC "considers an equity investment in a corporation to be a direct benefit because the company thereby receives additional working capital. Thus, when a borrower uses a loan to purchase newly-issued stock in a corporation, the latter has received the benefits of the proceeds and the investor's loan must be combined with any loans to the corporation.").[8]

Respondents' violations were not technical or minor violations. They were, instead, violations of law, policy, and prudent banking practices that are designed to protect the Bank from the very harm it suffered here. For these reasons, the Board finds that Respondents' misconduct demonstrated willful disregard and an order of prohibition against them is justified.

2. *Procedural Issues Challenged By Respondents*—The Board also finds that none of the four procedural issues raised by Respondents is sufficient to deny an order of prohibition in this case. In general, the Board defers to evidentiary and trial management rulings by an ALJ "in

7. In any event, Respondents' contemporaneous statements make clear that they did understand that the borrowers would transfer the loan proceeds to NCH. For example, in a December 13, 1996 letter to the USDA, Diehl McCarthy stated that Crowley, Nemetz, and Johnston would each contribute to NCH the precise amount which they subsequently borrowed from the Bank, and that each would "lend these funds to [NCH]" and that "NCH's pro forma balance sheet will indicate that the funds are converted to stock." (OCC Exh. 55).

8. Thus, the "bona fide sale" exception to the direct benefit rule, 12 CFR 32.5(b), is inapplicable even under Respondents' view of the case.

absence of an abuse of discretion or manifest unfairness." *In the Matter of Augustus I. Cavallari*, 80 *Federal Reserve Bulletin*, 1046, 1049 (1994). No such abuse or unfairness if evident here and the ALJ's rulings are therefore sustained.

First, Respondents argue that the ALJ improperly used official notice to absolve the OCC of its burden to establish jurisdiction in this case. Specifically, Respondents challenge the ALJ's post-hearing acceptance and subsequent official notice of information from the FDIC's official website to the effect that at all relevant times, the Bank was an "insured depository institution," a prerequisite to Respondents' status as "institution-affiliated parties" as defined by 12 U.S.C. § 1813(u).

The ALJ's action was both appropriate and timely. The OCC's regulations permit the ALJ to take official notice of "any material fact which may be judicially noticed by a United States district court and any material information in the official public records of any Federal or state government agency." 12 CFR 19.36(b)(1). Similar information to that accepted here has been subject of judicial notice in civil cases in the federal courts. *See, e.g., In re Wellbutrin SR/Zyban Antitrust Litigation*, 2003 WL 22099725 (E.D. Pa. 2003); *Morris v. Valesco*, 2003 WL 21397742 (N.D. Ill. 2003); *Ligon v. Doherty*, 208 F. Supp. 2d 384 (E.D.N.Y. 2002). Moreover, Respondents have not suggested that the information on the FDIC web site regarding the Bank's insured status was in any way flawed or incorrect.[9]

Nor was it improper for the ALJ to have accepted this material after the hearing. Respondents were on notice of Enforcement Counsel's request to take judicial notice and had a full opportunity to object. In addition, as the ALJ explained in her August 6, 2002 Order, Federal Rules of Evidence 201(d) and (f), applicable by analogy, permit judicial notice to be taken "at any stage of the proceeding" and mandate that official notice be taken if a party requests it and supplies the necessary information. Here, the OCC requested that the ALJ take official notice regarding the insured status of the Bank and supplied the necessary information as described in 12 CFR 19.36(b). Accordingly, the ALJ properly took official notice of the OCC's post-hearing submission.

Second, Respondents contend that they were denied their right to counsel because the "sequestration" order entered by the ALJ in this case prohibited them "from speaking to their counsel regarding the case while they were on the stand . . . including overnight breaks." (Respondents' Exceptions at p. 14). Respondents claim that the sequestration order violates their right to counsel under the Administrative Procedure Act, 5 U.S.C. § 555(b), the OCC's procedural rules at 12 CFR 19.183(b), and the Sixth Amendment to the Constitution. (Respondents' Exceptions at pp. 14–17).

None of these sources provides a basis to hold that the ALJ's order, which prohibited only discussion of a witness's *testimony* while he or she was under oath (Trans. 2594, 2806), was improper. While the Administrative Procedure Act allows parties to be "accompanied, represented, and advised by counsel," it does not state or suggest that parties are entitled to discuss their on-going testimony with counsel while on breaks at an administrative hearing. The regulation cited by Respondents, 12 CFR 19.183, applies to *investigative* testimony, not testimony given at an administrative hearing. Finally, the protections provided by the Sixth Amendment to the United States Constitution do not apply to administrative hearings because such protections "are explicitly confined to 'criminal prosecutions.'" *Austin v. United States*, 509 U.S. 603, 608 (1993); *see also United States v. Ward*, 448 U.S. 242, 248 (1980).[10]

Third, Respondents assert that the ALJ prevented them from recalling certain OCC witnesses for further testimony after their cross-examination of those witnesses, and as such, that they were denied their right to cross-examine and confront witnesses. (Respondents' Exceptions p. 17–19). The ALJ stated that she would consider permitting additional testimony from a witness who already had testified if Respondents submitted information as to the topics to be covered and how the testimony would provide relevant and non-repetitive information. This requirement was certainly within the ALJ's discretion to control the flow of witnesses at the hearing. Respondents failed to provide such information within the time permitted by the ALJ. As such, Respondents' argument is now moot.

Fourth, Respondents argue that the OCC never alleged unsafe and unsound banking practices or breach of fiduciary duties in its original Notice of Intent, and thus that the ALJ should have dismissed all testimony and evidence related to such claims.

The OCC's rules permit the ALJ conform the notice to the evidence where issues not raised in the notice are tried at the hearing by express or implied consent of the parties, or where the objecting party fails to show that admission of such evidence would unfairly prejudice the party's defense. 12 CFR 19.20(b). Here, Respondents were aware at least through the evidence introduced at the hearing that the allegations against them went beyond lending limit violations and involved the structure and approval of the loans, as well as the creditworthiness of the borrowers, and they failed to object to the introduction of such evidence at the hearings. For example, neither Respondent objected to the introduction of OCC Exhibit 140, the Bank's extensive loan policy manual. (Trans. 107). Furthermore, both Respondents testified at the hearing regarding the issues of the borrowers' creditworthiness and of compliance with loan policies and procedures. (*See, e.g.*, Trans. 2776–78 (Ulrich); Trans. 3086, 3089–90, 3104–06, 3108–13, 3176–77, 3262, 3264–75, 3279–80 (Diehl McCarthy)).[11]

---

9. Respondents claim that they contested the Bank's insured status in their Answers. In fact, their answers claimed only that they lacked sufficient information to respond to the allegation that the Bank was an insured depository institution, and on that basis the allegation was denied.

10. Even under the Sixth Amendment, a criminal defendant "has no constitutional right to consult with his lawyer while he is testifying." *Perry v. Leeke*, 488 U.S. 272, 281 (1989).

11. Respondents also insist that the ALJ improperly excluded testimony from their witness, John Moulton, regarding the creditworthiness of the borrowers. (Respondents' Exceptions at p. 24). The

Conclusion

For these reasons, the Board orders the issuance of the attached Orders of Prohibition.[12]

By order of the Board of Governors, this 15th day of October 2003.

Board of Governors of the
Federal Reserve System

ROBERT DEV. FRIERSON
Deputy Secretary of the Board

Order of Prohibition

Whereas, pursuant to section 8(e) of the Federal Deposit Insurance Act, as amended, (the "FDI 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 GENE ULRICH ("Ulrich");

NOW, THEREFORE, IT IS HEREBY ORDERED, pursuant to section 8(e) of the Federal Deposit Insurance Act, as amended, (12 U.S.C. § 1818(e)), that:

1. Ulrich, without the prior written approval of the Board of Governors and, where necessary pursuant to section 8(e)(7)(B) of the FDI Act (12 U.S.C. § 1818(e)(7)(B), another federal financial institution regulatory agency, is hereby and henceforth prohibited:
   (a) from participating in any manner in the conduct of the affairs of any institution or agency specified in section 8(e)(7)(A) of the FDI Act (12 U.S.C. § 1818(e)(7)(A)), including, but not limited to, any insured depository institution, any insured depository institution holding company or any U.S. branch or agency of a foreign banking organization;
   (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 FDI Act (12 U.S.C. § 1818(e)(7)(A));
   (c) from violating any voting agreement previously approved by any federal banking agency; or
   (d) from voting for a director, or serving or acting as an institution-affiliated party as defined in section 3(u) of the FDI Act, such as an officer, director, or employee in any institution described in section 8(e)(7)(A) of the FDI Act (12 U.S.C. § 1818(e)(7)(A)).
2. Any violation of this Order shall separately subject Ulrich to appropriate civil or criminal penalties or both under section 8 of the FDI Act (12 U.S.C. § 1818).
3. This Order, and each and every 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 at the expiration of thirty days after service is made.

By order of the Board of Governors, this 15th day of October 2003.

Board of Governors of the
Federal Reserve System

ROBERT DEV. FRIERSON
Deputy Secretary of the Board

Order of Prohibition

Whereas, pursuant to section 8(e) of the Federal Deposit Insurance Act, as amended, (the "FDI 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 SUSAN DIEHL McCARTHY ("Diehl McCarthy");

NOW, THEREFORE, IT IS HEREBY ORDERED, pursuant to section 8(e) of the Federal Deposit Insurance Act, as amended, (12 U.S.C. § 1818(e)), that:

1. Diehl McCarthy, without the prior written approval of the Board of Governors and, where necessary pursuant to section 8(e)(7)(B) of the FDI Act (12 U.S.C. § 1818(e)(7)(B), another federal financial institution regulatory agency, is hereby and henceforth prohibited:
   (a) from participating in any manner in the conduct of the affairs of any institution or agency specified in section 8(e)(7)(A) of the FDI Act (12 U.S.C. § 1818(e)(7)(A)), including, but not limited to, any insured depository institution, any insured depository institution holding company or any U.S. branch or agency of a foreign banking organization;
   (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 FDI Act (12 U.S.C. § 1818(e)(7)(A));
   (c) from violating any voting agreement previously approved by any federal banking agency; or

Board concludes that the ALJ properly excluded such evidence. Respondents did not indicate in their pre-hearing filings that Mr. Moulton would testify about the borrowers' creditworthiness, even after the issue was raised by the OCC's witness designations. (Trans. 3664–3670).

12. Respondents have requested oral argument but have not established good cause for such a request or identified reasons why arguments cannot be presented adequately in writing. Accordingly, their request is denied. 12 CFR 263.40(b).

(d) from voting for a director, or serving or acting as an institution-affiliated party as defined in section 3(u) of the FDI Act, such as an officer, director, or employee in any institution described in section 8(e)(7)(A) of the FDI Act (12 U.S.C. § 1818(e)(7)(A)).

2. Any violation of this Order shall separately subject Diehl McCarthy to appropriate civil or criminal penalties or both under section 8 of the FDI Act (12 U.S.C. § 1818).

3. This Order, and each and every 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 at the expiration of thirty days after service is made.

By order of the Board of Governors, this 15th day of October 2003.

Board of Governors of the
Federal Reserve System

ROBERT DEV. FRIERSON
Deputy Secretary of the Board

Federal Reserve Board of Governors and Official Staff

ALAN GREENSPAN, *Chairman*
ROGER W. FERGUSON, JR., *Vice Chairman*
EDWARD M. GRAMLICH
SUSAN SCHMIDT BIES

OFFICE OF BOARD MEMBERS

MICHELLE A. SMITH, *Director*
WINTHROP P. HAMBLEY, *Assistant to the Board and Director for Congressional Liaison*
ROSANNA PIANALTO-CAMERON, *Special Assistant to the Board*
DAVID W. SKIDMORE, *Special Assistant to the Board*
LARICKE D. BLANCHARD, *Special Assistant to the Board for Congressional Liaison*

LEGAL DIVISION

SCOTT G. ALVAREZ, *General Counsel*
RICHARD M. ASHTON, *Associate General Counsel*
STEPHANIE MARTIN, *Associate General Counsel*
KATHLEEN M. O'DAY, *Associate General Counsel*
ANN E. MISBACK, *Assistant General Counsel*
KATHERINE H. WHEATLEY, *Assistant General Counsel*
CARY K. WILLIAMS, *Assistant General Counsel*

OFFICE OF THE SECRETARY

JENNIFER J. JOHNSON, *Secretary*
ROBERT DEV. FRIERSON, *Deputy Secretary*
MARGARET M. SHANKS, *Assistant Secretary*

DIVISION OF BANKING SUPERVISION AND REGULATION

RICHARD SPILLENKOTHEN, *Director*
STEPHEN M. HOFFMAN, JR., *Deputy Director*
HERBERT A. BIERN, *Senior Associate Director*
ROGER T. COLE, *Senior Associate Director*
MICHAEL G. MARTINSON, *Senior Adviser*
DEBORAH P. BAILEY, *Associate Director*
NORAH M. BARGER, *Associate Director*
BETSY CROSS, *Associate Director*
GERALD A. EDWARDS, JR., *Associate Director*
JAMES V. HOUPT, *Associate Director*
JACK P. JENNINGS, *Associate Director*
PETER J. PURCELL, *Associate Director*
MOLLY S. WASSOM, *Associate Director*
DAVID M. WRIGHT, *Associate Director*
HOWARD A. AMER, *Deputy Associate Director*
BARBARA J. BOUCHARD, *Deputy Associate Director*
ANGELA DESMOND, *Deputy Associate Director*
JAMES A. EMBERSIT, *Deputy Associate Director*
CHARLES H. HOLM, *Deputy Associate Director*
WILLIAM G. SPANIEL, *Deputy Associate Director*
STACY COLEMAN, *Assistant Director*
JON D. GREENLEE, *Assistant Director*
WALT H. MILES, *Assistant Director*
WILLIAM C. SCHNEIDER, JR., *Assistant Director*
WILLIAM F. TREACY, *Assistant Director*

DIVISION OF INTERNATIONAL FINANCE

KAREN H. JOHNSON, *Director*
DAVID H. HOWARD, *Deputy Director*
THOMAS A. CONNORS, *Associate Director*
WILLIAM L. HELKIE, *Senior Adviser*
DALE W. HENDERSON, *Senior Adviser*
RICHARD T. FREEMAN, *Deputy Associate Director*
STEVEN B. KAMIN, *Deputy Associate Director*
JON W. FAUST, *Assistant Director*
JOSEPH E. GAGNON, *Assistant Director*
WILLENE A. JOHNSON, *Adviser*
MICHAEL P. LEAHY, *Assistant Director*
D. NATHAN SHEETS, *Assistant Director*
RALPH W. TRYON, *Assistant Director*

DIVISION OF RESEARCH AND STATISTICS

DAVID J. STOCKTON, *Director*
EDWARD C. ETTIN, *Deputy Director*
DAVID W. WILCOX, *Deputy Director*
MYRON L. KWAST, *Associate Director*
STEPHEN D. OLINER, *Associate Director*
PATRICK M. PARKINSON, *Associate Director*
LAWRENCE SLIFMAN, *Associate Director*
CHARLES S. STRUCKMEYER, *Associate Director*
DAVID L. REIFSCHNEIDER, *Deputy Associate Director*
WILLIAM L. WASCHER III, *Deputy Associate Director*
ALICE PATRICIA WHITE, *Deputy Associate Director*
JOYCE K. ZICKLER, *Deputy Associate Director*
DOUGLAS ELMENDORF, *Assistant Director*
MICHAEL GIBSON, *Assistant Director*
DIANA HANCOCK, *Assistant Director*
J. NELLIE LIANG, *Assistant Director*
S. WAYNE PASSMORE, *Assistant Director*
JANICE SHACK-MARQUEZ, *Assistant Director*
DANIEL SICHEL, *Assistant Director*
MARY M. WEST, *Assistant Director*
GLENN B. CANNER, *Senior Adviser*
DAVID S. JONES, *Senior Adviser*
THOMAS D. SIMPSON, *Senior Adviser*

DIVISION OF MONETARY AFFAIRS

VINCENT R. REINHART, *Director*
BRIAN F. MADIGAN, *Deputy Director*
JAMES A. CLOUSE, *Deputy Associate Director*
WILLIAM C. WHITESELL, *Deputy Associate Director*
CHERYL L. EDWARDS, *Assistant Director*
WILLIAM B. ENGLISH, *Assistant Director*
ATHANASIOS ORPHANIDES, *Adviser*
NORMAND R.V. BERNARD, *Special Assistant to the Board*

MARK W. OLSON
BEN S. BERNANKE

DONALD L. KOHN

DIVISION OF CONSUMER AND COMMUNITY AFFAIRS

SANDRA F. BRAUNSTEIN, *Director*
GLENN E. LONEY, *Deputy Director*
ADRIENNE D. HURT, *Associate Director*
IRENE SHAWN MCNULTY, *Associate Director*
JAMES A. MICHAELS, *Assistant Director*
TONDA E. PRICE, *Assistant Director*

OFFICE OF STAFF DIRECTOR FOR MANAGEMENT

STEPHEN R. MALPHRUS, *Staff Director*
SHEILA CLARK, *EEO Programs Director*
LYNN S. FOX, *Senior Adviser*

MANAGEMENT DIVISION

H. FAY PETERS, *Director*
STEPHEN J. CLARK, *Associate Director*
DARRELL R. PAULEY, *Associate Director*
CHRISTINE M. FIELDS, *Assistant Director*
BILLY J. SAULS, *Assistant Director*
DONALD A. SPICER, *Assistant Director*

DIVISION OF INFORMATION TECHNOLOGY

MARIANNE M. EMERSON, *Director*
MAUREEN T. HANNAN, *Deputy Director*
TILLENA G. CLARK, *Assistant Director*
GEARY L. CUNNINGHAM, *Assistant Director*
WAYNE A. EDMONDSON, *Assistant Director*
PO KYUNG KIM, *Assistant Director*
SUSAN F. MARYCZ, *Assistant Director*
SHARON L. MOWRY, *Assistant Director*
RAYMOND ROMERO, *Assistant Director*

DIVISION OF RESERVE BANK OPERATIONS AND PAYMENT SYSTEMS

LOUISE L. ROSEMAN, *Director*
PAUL W. BETTGE, *Associate Director*
JEFFREY C. MARQUARDT, *Associate Director*
KENNETH D. BUCKLEY, *Assistant Director*
JOSEPH H. HAYES, JR., *Assistant Director*
LISA HOSKINS, *Assistant Director*
DOROTHY LACHAPELLE, *Assistant Director*
MARSHA W. REIDHILL, *Assistant Director*
JEFF J. STEHM, *Assistant Director*
JACK K. WALTON II, *Assistant Director*

OFFICE OF THE INSPECTOR GENERAL

BARRY R. SNYDER, *Inspector General*
DONALD L. ROBINSON, *Deputy Inspector General*

Federal Open Market Committee and Advisory Councils

FEDERAL OPEN MARKET COMMITTEE

MEMBERS

ALAN GREENSPAN, *Chairman*

TIMOTHY F. GEITHNER, *Vice Chairman*

BEN S. BERNANKE
SUSAN SCHMIDT BIES
ROGER W. FERGUSON, JR.
EDWARD M. GRAMLICH
THOMAS M. HOENIG
DONALD L. KOHN
CATHY E. MINEHAN
MARK W. OLSON
SANDRA PIANALTO
WILLIAM POOLE

ALTERNATE MEMBERS

CHRISTINE M. CUMMING
ROBERT D. MCTEER, JR.
MICHAEL H. MOSKOW
GARY H. STERN
ANTHONY M. SANTOMERO

STAFF

VINCENT R. REINHART, *Secretary and Economist*
NORMAND R.V. BERNARD, *Deputy Secretary*
MICHELLE A. SMITH, *Assistant Secretary*
THOMAS C. BAXTER, JR., *Deputy General Counsel*
KAREN H. JOHNSON, *Economist*
DAVID J. STOCKTON, *Economist*
THOMAS A. CONNORS, *Associate Economist*
JEFFREY C. FUHRER, *Associate Economist*
CRAIG S. HAKKIO, *Associate Economist*
DAVID H. HOWARD, *Associate Economist*
BRIAN F. MADIGAN, *Associate Economist*
ROBERT H. RASCHE, *Associate Economist*
LAWRENCE SLIFMAN, *Associate Economist*
MARK S. SNIDERMAN, *Associate Economist*
DAVID W. WILCOX, *Associate Economist*

DINO KOS, *Manager, System Open Market Account*

FEDERAL ADVISORY COUNCIL

VACANT, *President*
DAVID W. KEMPER, *Vice President*

VACANT, First District
THOMAS A. RENYI, Second District
RUFUS A. FULTON, JR., Third District
MARTIN G. MCGUINN, Fourth District
FRED L. GREEN III, Fifth District
C. DOWD RITTER, Sixth District
DENNIS J. KUESTER, Seventh District
DAVID W. KEMPER, Eighth District
JERRY A. GRUNDHOFER, Ninth District
BYRON G. THOMPSON, Tenth District
GAYLE M. EARLS, Eleventh District
VACANT, Twelfth District

JAMES ANNABLE, *Secretary*

CONSUMER ADVISORY COUNCIL

AGNES BUNDY SCANLAN, Boston, Massachusetts, *Chairman*
MARK PINSKY, Philadelphia, Pennsylvania, *Vice Chairman*

DENNIS L. ALGIERE, Westerly, Rhode Island
JANIE BARRERA, San Antonio, Texas
KENNETH P. BORDELON, Baton Rouge, Louisiana
SUSAN BREDEHOFT, Cherry Hill, New Jersey
SHEILA CANAVAN, Moab, Utah
ROBIN COFFEY, Chicago, Illinois
ANNE DIEDRICK, New York, New York
DAN DIXON, Washington, District of Columbia
HATTIE B. DORSEY, Atlanta, Georgia
THOMAS FITZGIBBON, Chicago, Illinois
JAMES GARNER, Baltimore, Maryland
R. CHARLES GATSON, Kansas City, Missouri
LARRY HAWKINS, Houston, Texas
W. JAMES KING, Cincinnati, Ohio
RUHI MAKER, Rochester, New York
PATRICIA MCCOY, Cambridge, Massachusetts
ELSIE MEEKS, Kyle, South Dakota
BRUCE B. MORGAN, Roeland Park, Kansas
DEBRA S. REYES, Tampa, Florida
BENSON ROBERTS, Washington, District of Columbia
BENJAMIN ROBINSON III, Charlotte, North Carolina
MARY JANE SEEBACH, Calabasas, California
PAUL J. SPRINGMAN, Atlanta, Georgia
FORREST F. STANLEY, Cleveland, Ohio
LORI R. SWANSON, St. Paul, Minnesota
DIANE THOMPSON, East St. Louis, Illinois
HUBERT VAN TOL, Sparta, Wisconsin
CLINT WALKER, Wilmington, Delaware

THRIFT INSTITUTIONS ADVISORY COUNCIL

WILLIAM J. SMALL, Defiance, Ohio, *President*
D. TAD LOWREY, Brea, California, *Vice President*

ELDON R. ARNOLD, Peoria, Illinois
H. BRENT BEESLEY, St. George, Utah
MICHAEL J. BROWN, SR., Ft. Pierce, Florida
RICHARD J. DRISCOLL, Arlington, Texas
DOUGLAS K. FREEMAN, Alpharetta, Georgia
CURTIS L. HAGE, Sioux Falls, South Dakota
DAVID H. HANCOCK, Grandview, Missouri
OLAN O. JONES, JR., Kingsport, Tennessee
GEORGE W. NISE, Philadelphia, Pennsylvania
ROY M. WHITEHEAD, Seattle Washington

Federal Reserve Board Publications

For ordering assistance, write PUBLICATIONS FULFILLMENT, MS-127, Board of Governors of the Federal Reserve System, Washington, DC 20551, or telephone (202) 452-3245, or FAX (202) 728-5886. *You may also use the publications order form available on the Board's World Wide Web site* (www.federalreserve.gov). *When a charge is indicated, payment should accompany request and be made payable to the Board of Governors of the Federal Reserve System or may be ordered via MasterCard, VISA, or American Express. Payment from foreign residents should be drawn on a U.S. bank.*

BOOKS AND MISCELLANEOUS PUBLICATIONS

THE FEDERAL RESERVE SYSTEM—PURPOSES AND FUNCTIONS. 1994. 157 pp.

ANNUAL REPORT, 2003.

ANNUAL REPORT: BUDGET REVIEW, 2004.

FEDERAL RESERVE BULLETIN. Quarterly. $10.00 per year or $2.50 each in the United States, its possessions, Canada, and Mexico. Elsewhere, $15.00 per year or $3.50 each.

STATISTICAL SUPPLEMENT TO THE FEDERAL RESERVE BULLETIN. Monthly. $25.00 per year or $2.50 each in the United States, its possessions, Canada, and Mexico. Elsewhere, $35.00 per year or $3.50 each.

ANNUAL STATISTICAL DIGEST: period covered, release date, number of pages, and price.

1981	October 1982	239 pp.	$ 6.50
1982	December 1983	266 pp.	$ 7.50
1983	October 1984	264 pp.	$11.50
1984	October 1985	254 pp.	$12.50
1985	October 1986	231 pp.	$15.00
1986	November 1987	288 pp.	$15.00
1987	October 1988	272 pp.	$15.00
1988	November 1989	256 pp.	$25.00
1980–89	March 1991	712 pp.	$25.00
1990	November 1991	185 pp.	$25.00
1991	November 1992	215 pp.	$25.00
1992	December 1993	215 pp.	$25.00
1993	December 1994	281 pp.	$25.00
1994	December 1995	190 pp.	$25.00
1990–95	November 1996	404 pp.	$25.00
1996–2000	March 2002	352 pp.	$25.00

REGULATIONS OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

ANNUAL PERCENTAGE RATE TABLES (Truth in Lending—Regulation Z) *Vol. I* (Regular Transactions). 1969. 100 pp. *Vol. II* (Irregular Transactions). 1969. 116 pp. Each volume $5.00.

GUIDE TO THE FLOW OF FUNDS ACCOUNTS. January 2000. 1,186 pp. $20.00 each.

FEDERAL RESERVE REGULATORY SERVICE. Loose-leaf; updated monthly. (Requests must be prepaid.)
- Consumer and Community Affairs Handbook. $75.00 per year.
- Monetary Policy and Reserve Requirements Handbook. $75.00 per year.
- Securities Credit Transactions Handbook. $75.00 per year.
- The Payment System Handbook. $75.00 per year.
- Federal Reserve Regulatory Service. Four vols. (Contains all four Handbooks plus substantial additional material.) $200.00 per year.

Rates for subscribers outside the United States are as follows and include additional air mail costs:
- Federal Reserve Regulatory Service, $250.00 per year.
- Each Handbook, $90.00 per year.

FEDERAL RESERVE REGULATORY SERVICE FOR PERSONAL COMPUTERS. CD-ROM; updated monthly.
- Standalone PC. $300 per year.
- Network, maximum 1 concurrent user. $300 per year.
- Network, maximum 10 concurrent users. $750 per year.
- Network, maximum 50 concurrent users. $2,000 per year.
- Network, maximum 100 concurrent users. $3,000 per year.

Subscribers outside the United States should add $50 to cover additional airmail costs.

EDUCATION PAMPHLETS

Short pamphlets suitable for classroom use. Multiple copies are available without charge.

Consumer Handbook on Adjustable Rate Mortgages (also available in Spanish)
Consumer Handbook to Credit Protection Laws
A Guide to Business Credit for Women, Minorities, and Small Businesses
Series on the Structure of the Federal Reserve System
- The Board of Governors of the Federal Reserve System
- The Federal Open Market Committee
- Federal Reserve Bank Board of Directors
- Federal Reserve Banks

A Consumer's Guide to Mortgage Lock-Ins
A Consumer's Guide to Mortgage Settlement Costs
A Consumer's Guide to Mortgage Refinancings
Home Mortgages: Understanding the Process and Your Right to Fair Lending
How to File a Consumer Complaint about a Bank (also available in Spanish)
In Plain English: Making Sense of the Federal Reserve
Making Sense of Savings
What You Should Know About Home Equity Lines of Credit (also available in Spanish)
Keys to Vehicle Leasing (also available in Spanish)
Looking for the Best Mortgage (also available in Spanish)
Privacy Choices for Your Personal Financial Information
When Is Your Check Not a Check? (also available in Spanish)
Putting Your Home on the Loan Line Is Risky Business (also available in Spanish)

STAFF STUDIES: Only Summaries Printed in the BULLETIN

Studies and papers on economic and financial subjects that are of general interest. Staff Studies 1–158, 161, 163, 165, 166, 168, and 169 are out of print, but photocopies of them are available. Staff Studies 165–176 are available online at www.federalreserve.gov/pubs/staffstudies. Requests to obtain single copies of any paper or to be added to the mailing list for the series may be sent to Publications.

159. New Data on the Performance of Nonbank Subsidiaries of Bank Holding Companies, by Nellie Liang and Donald Savage. February 1990. 12 pp.
160. Banking Markets and the Use of Financial Services by Small and Medium-Sized Businesses, by Gregory E. Elliehausen and John D. Wolken. September 1990. 35 pp.
162. Evidence on the Size of Banking Markets from Mortgage Loan Rates in Twenty Cities, by Stephen A. Rhoades. February 1992. 11 pp.
164. The 1989–92 Credit Crunch for Real Estate, by James T. Fergus and John L. Goodman, Jr. July 1993. 20 pp.
167. A Summary of Merger Performance Studies in Banking, 1980–93, and an Assessment of the "Operating Performance" and "Event Study" Methodologies, by Stephen A. Rhoades. July 1994. 37 pp.
170. The Cost of Implementing Consumer Financial Regulations: An Analysis of Experience with the Truth in Savings Act, by Gregory Elliehausen and Barbara R. Lowrey. December 1997. 17 pp.
171. The Cost of Bank Regulation: A Review of the Evidence, by Gregory Elliehausen. April 1998. 35 pp.
172. Using Subordinated Debt as an Instrument of Market Discipline, by Study Group on Subordinated Notes and Debentures, Federal Reserve System. December 1999. 69 pp.
173. Improving Public Disclosure in Banking, by Study Group on Disclosure, Federal Reserve System. March 2000. 35 pp.
174. Bank Mergers and Banking Structure in the United States, 1980–98, by Stephen Rhoades. August 2000. 33 pp.
175. The Future of Retail Electronic Payments Systems: Industry Interviews and Analysis, Federal Reserve Staff, for the Payments System Development Committee, Federal Reserve System. December 2002. 27 pp.
176. Bank Merger Activity in the United States, 1994–2003, by Steven J. Pilloff. May 2004. 23 pp.

ANTICIPATED SCHEDULE OF RELEASE DATES FOR PERIODIC RELEASES OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

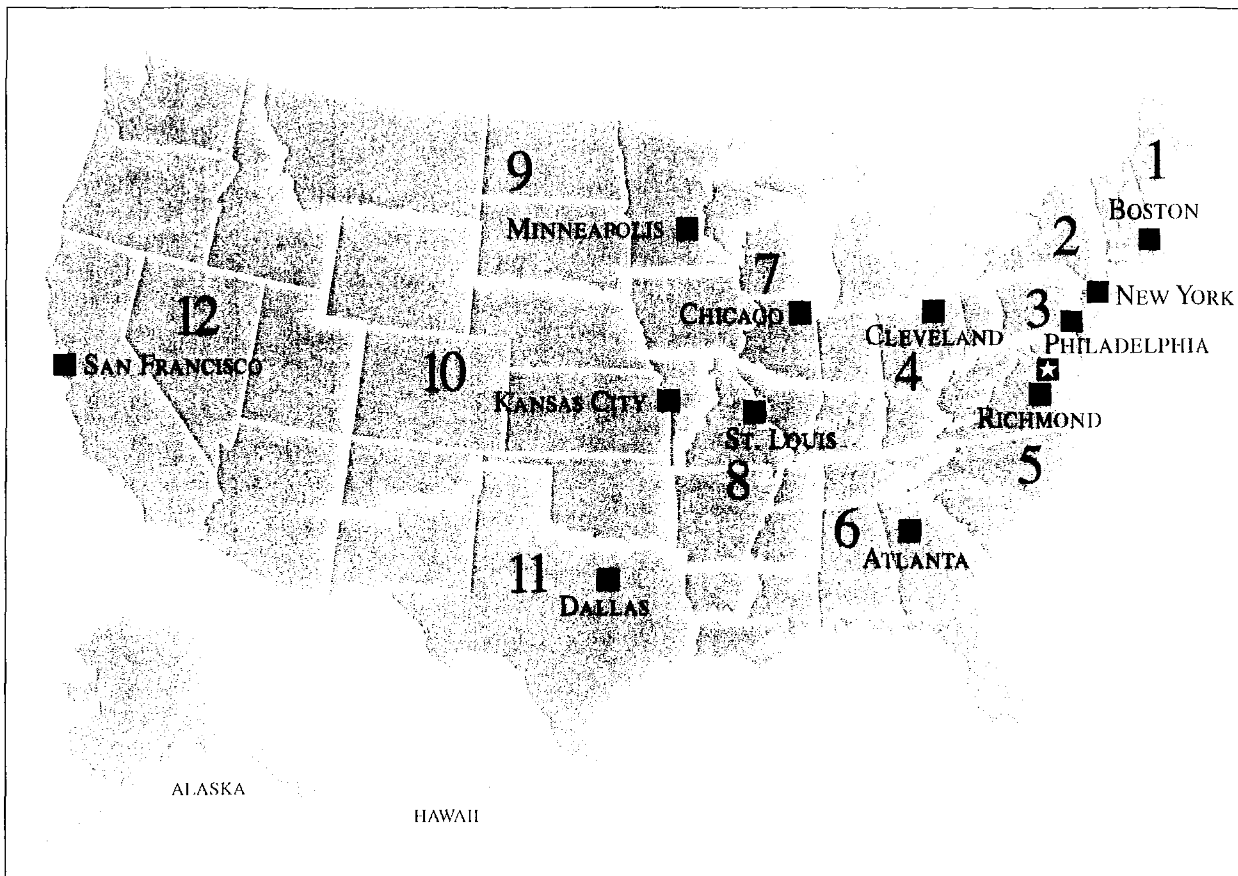
For ordering assistance, write PUBLICATIONS FULFILLMENT, MS-127, Board of Governors of the Federal Reserve System, Washington, DC 20551, or telephone (202) 452-3245, or FAX (202) 728-5886. *You may also use the publications order form available on the Board's World Wide Web site* (www.federalreserve.gov). *When a charge is indicated, payment should accompany request and be made payable to the Board of Governors of the Federal Reserve System or may be ordered via MasterCard, VISA, or American Express. Payment from foreign residents should be drawn on a U.S. bank.*

Release number and title	Annual mail rate	Annual fax rate	Approximate release days[1]	Period or date to which data refer	Corresponding *Bulletin* or *Statistical Supplement* table numbers[2]
Weekly Releases					
H.2. Actions of the Board: Applications and Reports Received	$55.00	n.a.	Friday	Week ending previous Saturday	. . .
H.3. Aggregate Reserves of Depository Institutions and the Monetary Base[3]	$20.00	n.a.	Thursday	Week ending previous Wednesday	1.20
H.4.1. Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks[3]	$20.00	n.a.	Thursday	Week ending previous Wednesday	1.11, 1.18
H.6. Money Stock Measures[3]	$35.00	n.a.	Thursday	Week ending Monday of previous week	1.21
H.8. Assets and Liabilities of Commercial Banks in the United States[3]	$30.00	n.a.	Friday	Week ending previous Wednesday	1.26A–F
H.10. Foreign Exchange Rates[3]	$20.00	$20.00	Monday	Week ending previous Friday	3.28
H.15. Selected Interest Rates[3]	$20.00	$20.00	Monday	Week ending previous Friday	1.35
Monthly Releases					
G.5. Foreign Exchange Rates[3]	$ 5.00	$ 5.00	First of month	Previous month	3.28
G.17. Industrial Production and Capacity Utilization[3]	$15.00	n.a.	Midmonth	Previous month	2.12, 2.13
G.19. Consumer Credit[3]	$ 5.00	$ 5.00	Fifth working day of month	Second month previous	1.55, 1.56
G.20. Finance Companies[3]	$ 5.00	n.a.	End of month	Second month previous	1.51, 1.52

Release number and title	Annual mail rate	Annual fax rate	Approximate release days[1]	Period or date to which data refer	Corresponding *Bulletin* or *Statistical Supplement* table numbers[2]
Quarterly Releases					
E.2. Survey of Terms of Business Lending[3]	$ 5.00	n.a.	Midmonth of March, June, September, and December	February, May, August, and November	4.23
E.11. Geographical Distribution of Assets and Liabilities of Major Foreign Branches of U.S. Banks	$ 5.00	n.a.	15th of March, June, September, and December	Previous quarter	. . .
E.16. Country Exposure Lending Survey[3]	$ 5.00	n.a.	January, April, July, and October	Previous quarter	. . .
Z.1. Flow of Funds Accounts of the United States: Flows and Outstandings[3]	$25.00	n.a.	Second week of March, June, September, and December	Previous quarter	1.57, 1.58, 1.59, 1.60

1. Please note that for some releases, there is normally a certain variability in the release date because of reporting or processing procedures. Moreover, for all series unusual circumstances may, from time to time, result in a release date being later than anticipated.
2. Beginning with the Winter 2004 issue (vol. 90, no. 1) of the *Bulletin*, the corresponding table for the statistical release no longer appears in the *Bulletin*. Statistical tables are now published in the *Statistical Supplement to the Federal Reserve Bulletin*; the table numbers, however, remain the same.
3. These releases are also available on the Board's web site, www.federalreserve.gov/releases.
n.a. Not available.

Maps of the Federal Reserve System



LEGEND

Both pages

■ Federal Reserve Bank city

⧈ Board of Governors of the Federal Reserve System, Washington, D.C.

Facing page

• Federal Reserve Branch city

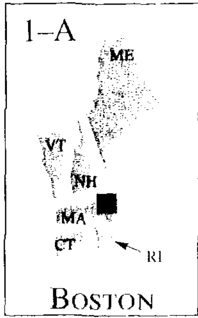
— Branch boundary

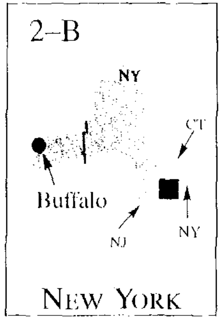
NOTE

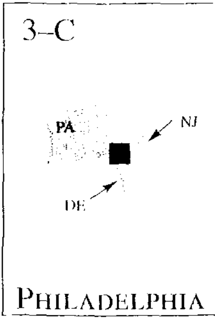
The Federal Reserve officially identifies Districts by number and Reserve Bank city (shown on both pages) and by letter (shown on the facing page).

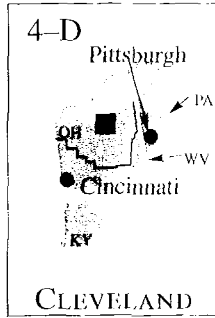
In the 12th District, the Seattle Branch serves Alaska, and the San Francisco Bank serves Hawaii.

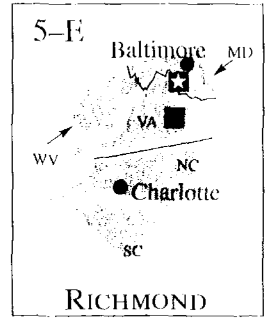
The System serves commonwealths and territories as follows: the New York Bank serves the Commonwealth of Puerto Rico and the U.S. Virgin Islands; the San Francisco Bank serves American Samoa, Guam, and the Commonwealth of the Northern Mariana Islands. The Board of Governors revised the branch boundaries of the System most recently in February 1996.

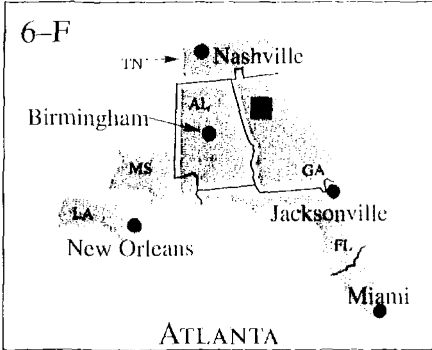

1–A
ME
VT
NH
MA
CT
RI
BOSTON


2–B
NY
CT
Buffalo
NJ
NY
NEW YORK


3–C
PA
NJ
DE
PHILADELPHIA

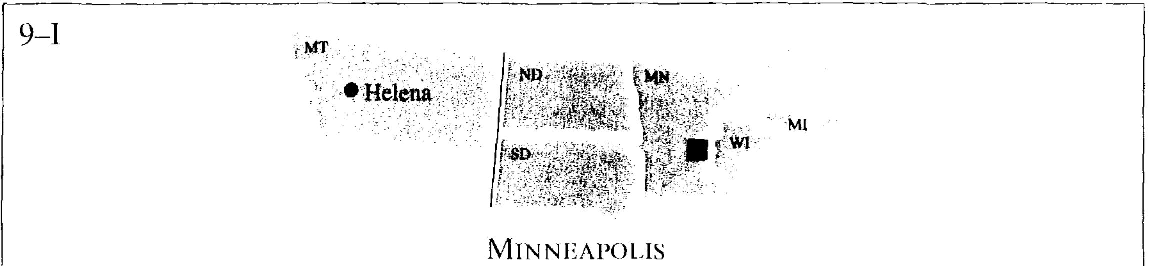

4–D
Pittsburgh
PA
OH
WV
Cincinnati
KY
CLEVELAND

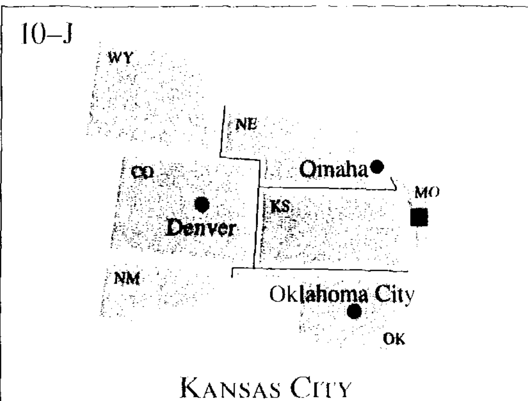

5–E
Baltimore
MD
VA
WV
NC
Charlotte
SC
RICHMOND

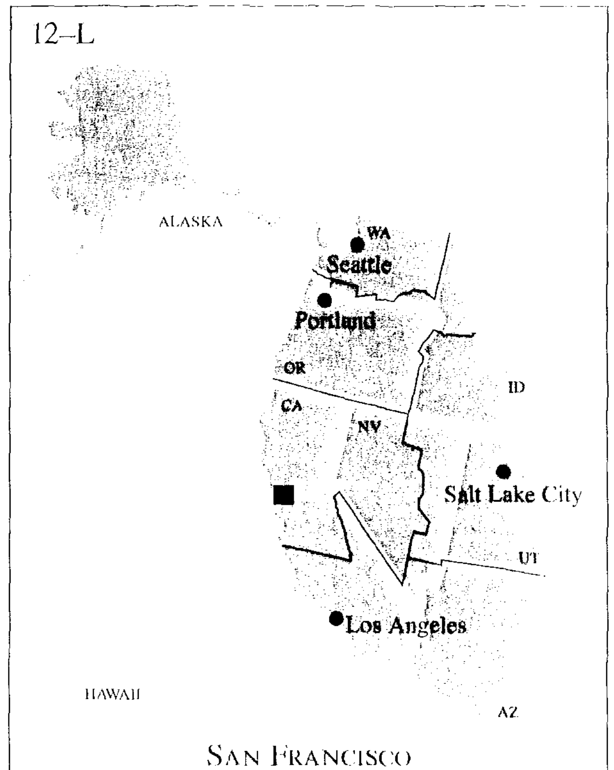

6–F
TN
Nashville
Birmingham
AL
MS
GA
LA
Jacksonville
New Orleans
FL
Miami
ATLANTA

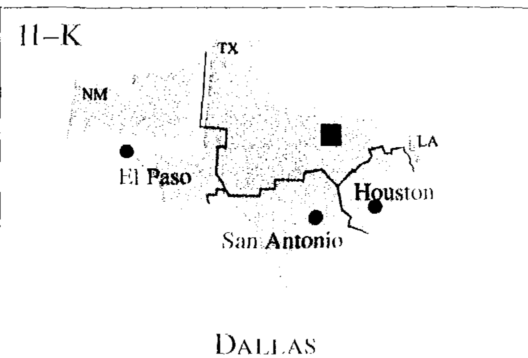
7–G
MI
WI
IA
Detroit
IL
IN
CHICAGO

8–H
KY
IL
IN
Louisville
MO
TN
AR
Memphis
Little Rock
MS
ST. LOUIS


9–I
MT
Helena
ND
MN
SD
WI
MI
MINNEAPOLIS


10–J
WY
NE
CO
Omaha
MO
KS
Denver
NM
Oklahoma City
OK
KANSAS CITY


12–L
ALASKA
WA
Seattle
Portland
OR
ID
CA
NV
Salt Lake City
UT
Los Angeles
HAWAII
AZ
SAN FRANCISCO


11–K
TX
NM
LA
El Paso
Houston
San Antonio
DALLAS

Federal Reserve Banks, Branches, and Offices

FEDERAL RESERVE BANK branch, or *facility*	Zip	Chairman / Deputy Chairman	President / First Vice President	Vice President in charge of branch
BOSTON*	02106	Samuel O. Thier	Cathy E. Minehan	
		Blenda J. Wilson	Paul M. Connolly	
NEW YORK*	10045	John E. Sexton	Timothy F. Geithner	
		Jerry I. Speyer	Christine M. Cumming	
Buffalo	14240	Katherine E. Keough		Barbara L. Walter[1]
PHILADELPHIA	19105	Ronald J. Naples	Anthony M. Santomero	
		Doris M. Damm	William H. Stone, Jr.	
CLEVELAND*	44101	Robert W. Mahoney	Sandra Pianalto	
		Charles E. Bunch	Robert Christy Moore	
Cincinnati	45201	Dennis C. Cuneo		Barbara B. Henshaw
Pittsburgh	15230	Roy W. Haley		Robert B. Schaub
RICHMOND*	23219	Wesley S. Williams, Jr.	J. Alfred Broaddus, Jr.	
		Thomas J. Mackell, Jr.	Walter A. Varvel	
Baltimore	21203	Owen E. Herrnstadt		William J. Tignanelli[1]
Charlotte	28230	Michael A. Almond		Jeffrey S. Kane[1]
ATLANTA	30303	David M. Ratcliffe	Jack Guynn	
		V. Larkin Martin	Patrick K. Barron	James M. McKee[1]
Birmingham	35242	Catherine Crenshaw		Lee C. Jones
Jacksonville	32231	Julie Hilton		Christopher L. Oakley
Miami	33152	Rosa Sugranes		James T. Curry III
Nashville	37203	Rodney Lawler		Melvyn K. Purcell[1]
New Orleans	70161	Dave Dennis		Robert J. Musso[1]
CHICAGO*	60690	W. James Farrell	Michael H. Moskow	
		Miles D. White	Gordon R. G. Werkema	
Detroit	48231	Edsel B. Ford II		Glenn Hansen[1]
ST. LOUIS	63166	Walter L. Metcalfe, Jr.	William Poole	
		Gayle P. W. Jackson	W. LeGrande Rives	
Little Rock	72203	Scott T. Ford		Robert A. Hopkins
Louisville	40232	Cornelius A. Martin		Thomas A. Boone
Memphis	38101	Meredith B. Allen		Martha Perine Beard
MINNEAPOLIS	55480	Linda Hall Whitman	Gary H. Stern	
		Frank L. Sims	James M. Lyon	
Helena	59601	Dean Folkvord		Samuel H. Gane
KANSAS CITY	64198	Richard H. Bard	Thomas M. Hoenig	
		Robert A. Funk	Richard K. Rasdall	
Denver	80217	Thomas Williams		Pamela L. Weinstein
Oklahoma City	73125	Tyree O. Minner		Dwayne E. Boggs
Omaha	68102	A.F. Raimondo		Steven D. Evans
DALLAS	75201	Ray L. Hunt	Robert D. McTeer, Jr.	
		Patricia M. Patterson	Helen E. Holcomb	
El Paso	79999	Ron C. Helm		Robert W. Gilmer[3]
Houston	77252	Lupe Fraga		Robert Smith III[1]
San Antonio	78295	Ron R. Harris		James L. Stull[1]
SAN FRANCISCO	94120	George M. Scalise	Janet L. Yellen	
		Sheila D. Harris	John F. Moore	
Los Angeles	90051	William D. Jones		Mark L. Mullinix[2]
Portland	97208	Karla S. Chambers		Richard B. Hornsby
Salt Lake City	84125	H. Roger Boyer		Andrea P. Wolcott
Seattle	98124	Mic R. Dinsmore		Mark Gould

*Additional offices of these Banks are located at Windsor Locks, Connecticut 06096; East Rutherford, New Jersey 07016; Utica at Oriskany, New York 13424; Columbus, Ohio 43216; Columbia, South Carolina 29210; Charleston, West Virginia 25311; Des Moines, Iowa 50306; Indianapolis, Indiana 46204; Milwaukee, Wisconsin 53202; and Peoria, Illinois 61607.

1. Senior vice president
2. Executive vice president
3. Acting