

Commercial Banking Regulation

Introduction

Banks are central to the smooth functioning of an economy. They also have the ability to “create” money. As a result, banks are one of the most regulated entities in every country. There are several agencies that oversee banking in the United States including the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve, The Office of the Comptroller of the Currency, and the Securities and Exchange Commission. Savings and loans are similar to commercial banks and have their own regulatory bodies. This note will briefly discuss each of these institutions.

In addition to domestic regulators there are international banking rules that affect many of the largest U.S. banks.

The Federal Deposit Insurance Corporation

Deposit insurance, in one form or another, has existed in the United States since 1829, when New York became the first state to adopt a bank-obligation insurance program. The plan, conceived by Joshua Forman, a Syracuse businessman, had three principal components:

- The establishment of an insurance fund, to which all banks had to pay an assessment
- A board of commissioners, which was granted bank examination powers
- A specified list of investments for bank capital.

While it would be about 100 years later until deposit insurance would become more ubiquitous, this structure would remain common to the banking industry for many years, eventually evolving into the FDIC.

The Great Depression and the birth of the FDIC

The roots of the Federal Deposit Insurance Corporation began with the stock market crash of 1929 and the Great Depression that followed. Banking, like other industries, was swept up in the wave of speculation that engulfed the roaring ‘20s, as many banks were buying large amounts of high-risk securities (both debt and equity). However, along with a risky investment portfolio, there existed other contributing factors that put more financial strain on U.S. banks at this time. At the time, for instance, there was no regulation to control or separate between commercial and investment banking functions, which allowed larger savings banks to participate in the underwriting of securities. Additionally, banks sold stocks on margin, meaning they would actually loan money to investors to buy stocks, using the stocks as collateral on the loan. With

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the collapse of the stock market, not only did banks suffer because of their *own* devalued investments, but they also lost out on numerous failed loans whose collateral was now worthless, thereby compromising the solvency of banks in many parts of the country.

Other effects of the Great Depression pushed many banks deeper into distress as personal income declined and unemployment rose. Banks experienced a similar problem with mortgages as they did with margin loans as decreased personal income put many in default on their mortgages while deflation was eating away at the collateral value of the homes. Of the 25,000 banking institutions that existed in 1929, more than 11,000 (roughly 40%) would fail or be forced to merge by the end of 1933. Fear of further bank collapses also created a hypersensitive psychology in depositors, causing “runs” on many banks, where depositors would demand their money as soon as the slightest threat of failure was perceived. This action caused massive illiquidity problems throughout the banking industry. As these problems compounded and began to take their toll throughout the banking industry, the U.S. government was forced to act.

To alleviate depositors’ fears and bring much-needed stability to the banking industry, the U.S. government created the Federal Deposit Insurance Corporation (FDIC) as part of the Banking Act of 1933. This legislation mandated separation between commercial and investment banking institutions and gave the FDIC temporary authority to assess insurance fees and guarantee deposits up to \$2,500. The insurance assessment rate was set at .25% of deposits with an additional .25% payable on call. If a bank experienced extreme financial distress, the FDIC could either close it and pay off the insured depositors or find a suitable merger candidate and arrange for consolidation. Additional legislation in 1935 made the FDIC a permanent fixture in the U.S. government, raised the insured level for deposits to \$5,000 and set the assessment rate of insured banks at 0.083% of insured deposits. While banks continued to fail, the rate of insured bank failures decreased substantially and finally began to taper off as the economy slowly improved towards the end of the decade. This state of steady improvement would continue throughout the next several decades.

The Mid-Twentieth Century

Benefited by the economic calm following World War II, no more than seven insured banks failed in any one year from 1945-1970 (see Exhibits 1 and 2). With fewer failures, FDIC reserves grew steadily in proportion to insured deposits (see Exhibit 3), and banks began pressuring Congress to ease assessment rates. In response, the Federal Deposit Insurance Act of 1950 raised the insured deposit maximum to \$10,000, but kept the assessment rate at 0.083% of insured deposits. Instead of lowering the assessment rate, the legislation set up a rebate system whereby the FDIC would proportionally refund 40% of its operating surplus each year by crediting future bank assessments. Even more importantly, the FDIC was given authority to make loans to, or purchase assets from, an insured bank in order to facilitate mergers and consolidations, while also thwarting the risk of excessive payments from FDIC funds. Figure 1 outlines the three options available to the FDIC for resolving a failing bank.

Figure 1

FDIC OPTIONS FOR TROUBLED BANKS		
Purchase and Assumption	Closure	Provide Assistance
With this option, the FDIC identified a larger, more solvent bank that was willing to purchase the failed bank's assets and assume its liabilities. Under this scenario, deposits usually transferred from one bank to the next with the least amount of loss to the FDIC and inconvenience to the depositors. This is the most frequently used option.	With this option, the bank was simply closed, with the FDIC paying off insured depositors. To recoup its losses as much as possible, the FDIC sold off the closed bank's assets and took the place of the insured depositors in the creditors' queue. The FDIC employed this option when a buyer could not be found.	With this option, the FDIC provided assistance to a troubled bank when "the continued operation of the bank is essential to provide adequate banking service in the community."* Essentially, the FDIC provided financial help until the bank recovered. The FDIC strongly resisted using this option, however, because of its unfair benefit to shareholders and the potential impact on market discipline.

*Section 13(c) of the Banking Act of 1950.

To complement the FDIC's responsibility related to bank failures, the FDIC also began performing regulatory supervision of insured banks, similar to the operations performed by the Federal Reserve Board and other regulatory agencies. The supervision provided by the FDIC focused on a bank's financial and operational stability in relation to a number of federal laws including the Truth in Lending Act, the Fair Credit Reporting Act, the Fair Housing Act, the Community Reinvestment Act, the Home Mortgage Disclosure Act, and the Equal Credit Opportunity Act. The schedule for supervisory examinations varied depending on the past performance of the bank.

Throughout this period the banking industry performed well with banks managing to maintain financial security. This would change, however, in the early 1980's when the financial instability of savings and loan institutions and the FDIC's "too big to fail" (TBTF) doctrine, which is explained later, would impact the entire industry.

Savings and Loans

Savings and Loans (S&L's) existed in the United States since the nineteenth century. They were originally created to accept savings from the public and loan those funds out in the form of mortgage loans, thus providing a dual service to the local community. While this business model appeared to work for many years, it was only a matter of time before these institutions began to feel the pressure of drawing income from fixed-rate, long-term assets and paying out on short-term, floating rate liabilities.

From the early 1960s it became evident that the S&L industry was not competing effectively for funds with commercial banks and securities markets, leading to large swings in the amount of money available for mortgage lending. Part of the problem was that regulations put in place in the 1960's (e.g. Regulation Q) which put a ceiling on the interest rate that banks and S&Ls could offer to depositors. At first, this regulation helped to stave off competition for depositor funds between banks and S&Ls. However, in the 1970's and 1980's new money market funds began to compete fiercely for depositors' money by offering higher interest rates. For this reason, S&Ls suffered significant withdrawal of deposits during this period of high interest rates. Many savings institutions compensated for the drop in income by participating in higher-yield, risky investments.

When regulators responded by lifting the interest rate ceiling in the early 1980's an even larger problem occurred. In the high inflationary environment at that time, an unsustainable gap opened up for S&L's between the cost of their funding liabilities (short-term interest rates) and the income generated by their assets (long-term, fixed-rate mortgage repayments). Worse, as interest rates moved higher, the economic value of existing portfolios of long-term, low interest rate residential mortgages moved sharply lower, threatening institutions with insolvency.

When all was said and done, it would take several years and an estimated \$153 Billion in taxpayer money to mend the fractured Savings and Loan industry. This crisis would also affect the makeup of the banking industry and the deposit insurance structure in the United States.

Deposit Insurance in the 1980's

In 1980, legislation created a Designated Reserve Ratio (DRR) that mandated a target ratio range of FDIC funds to insured deposits between 1.10-1.40%. This legislation also raised the maximum coverage per depositor to \$100,000, an amount which had periodically increased over the years. With decades of incremental refinement and few problems, the future seemed bright for the banking industry and the FDIC.

Things changed in the 1980s when a recession in the early part of the decade brought on high inflation and rising interest rates. This especially caused huge problems within the S&L industry. Banking abruptly became a much more challenging business and failures skyrocketed from ten in 1979 to 119 in 1982 (see Exhibit 2). Suddenly multiple banks were competing for the same FDIC funds, and even when the FDIC didn't lose money while closing or merging a bank, funds would often be unavailable for a significant amount of time until the FDIC received reimbursement through liquidation efforts.

Of particular note was the case of the Continental Illinois National Bank and Trust Company. At the time, Continental was the nation's seventh largest bank with nearly \$40 billion in assets. Weakened by risky loans that had fueled its growth in the late 1970s and by a \$1 billion investment in the failed Penn Square Bank, Continental began a downward spiral from which it wouldn't recover. Finally, as non-performing loans hit record highs in the first quarter of 1984, Moody's was the first rating agency that announced a further review of Continental's credit rating.

Compounding this problem during the 1980's was the problem of disintermediation in which the largest and most credit worthy customers would no longer go to banks ("intermediaries") for financing needs but would go directly to the capital market for short term debt such as commercial paper or long term debt in the form of corporate bonds or debentures.

On May 11, Continental was forced to borrow \$3.6 billion in Federal Reserve discount loans, sending a direct signal to the market that its financial health was in jeopardy. A further \$4.5 billion loan package from 16 banks wasn't able to stem the tide one week later. The FDIC then provided \$2 billion in financing and the Federal Reserve announced that it would meet all of Continental's liquidity needs. On May 17, in an unprecedented move, the FDIC announced that it would guarantee all of Continental's depositors and general creditors regardless of the \$100,000 maximum. Finally, as part of a permanent plan, Continental's leadership was replaced and over \$6 billion of additional funding was provided by the FDIC.

The FDIC's preferential treatment of Continental Illinois when many other banks had failed in 1984 raised significant questions and fanned the flames of the Too Big To Fail (TBTF) policy. The crux of the issue stemmed from the FDIC's decision about whether or not to let Continental Illinois fail. A failure of Continental Illinois would have likely caused massive waves of uncertainty and fear regarding the safety of bank deposits. About 2100 banks held billions in uninsured deposits with Continental Illinois, of which 66 had deposits greater than their total equity and many more had deposits exceeding half their equity. In the end, the FDIC decided that it was better to act inequitably than risk widespread damage to the overall banking system.

The criticism of TBTF as well as the concurrent crisis within the Savings and Loan industry forced the FDIC to enact reforms in order to increase the overall health of the banking industry.

Deposit Insurance Reforms

The Savings and Loan Crisis of the late '80's and early '90's exposed several weaknesses in the nation's federal deposit insurance program. By 1989, The Federal Savings and Loan Insurance Corporation (FSLIC) was insolvent and the FDIC's DRR was at 0.70% (well below its mandated minimum level of 1.1%) for the second consecutive year (see Exhibit 4). Legislation in 1989 dissolved the FSLIC and transferred its supervisory operations to the newly created Office of Thrift Supervision (OTS) while the FDIC received authority to oversee the Savings Association Insurance Fund (SAIF), the new fund responsible for resolving future savings institution failures. Additionally, the FDIC was to administer the FSLIC Resolution Fund and the Resolution Trust Corporation (RTC) was established to sell off the hundreds of billions of dollars in failed thrift assets. Finally, the FDIC was given a \$5 billion line of credit with the U.S. Treasury in an attempt to demonstrate the government's continued support of the FDIC.

Further reforms came in 1991 with the FDIC Improvement Act (FDICIA). This legislation raised the minimum DRR to 1.25% and gave the FDIC authority to increase the frequency of assessments in order to maintain the DRR. To further address the deficit, the FDIC's Treasury credit was increased from \$5 billion to \$30 billion. These efforts were aimed at making the FDIC a solvent, faith-promoting institution again after its reserves had been depleted by the S&L crisis. Additionally, the FDIC Improvement Act mandated that the FDIC use the least costly option to resolve a bank failure. This directive, initially designed to limit the application of TBTF in

support of large failing banks, still afforded the FDIC the right to invoke TBTF practices in the best interests of the banking system if approved by the established decision-making process. Finally, this legislation required the FDIC to set up a risk-based assessment schedule for insured banks. The system in the early 21st century used nine risk categories established by a three-by-three matrix which considered capital ratios as well as supervision ratings (see Exhibit 5). Initially, these categories were assessed varying rates for their insurance with an assessment range of 0.00%-0.33%.

Once the insurance funds began to rise above the 1.25% minimum, the Deposit Insurance Act of 1996 eliminated the mandatory assessment for banks in the lowest-risk category. The idea was to make those banks with the greatest likelihood of failing responsible for ongoing financing. This new rule resulted in approximately 95% of banking institutions not having to pay any assessment. However, in 2007 the fast growth of banking deposits forced the FDIC to impose premiums averaging .05% to .07% of a bank's insured deposits. The Graham-Leach-Bliley Act of 1999 made it possible for commercial banks to once again offer a full range of financial services including brokerage, underwriting, and sponsoring/distributing mutual funds.

These changes to the FDIC throughout the latter part of the twentieth century decreased its privatized, independent nature by making it more dependent on government funding and making it possible for some banks to receive insurance without paying a premium.

Banking in the 21st Century

The commercial banking industry went through a great deal of change in the latter part of the twentieth century. Banks lost valuable income as steadily fewer top-rated U.S. corporations utilized bank loans as a source of capital beginning in the mid to late 1980's. These companies began to turn directly to capital markets to address their financing needs (see Exhibit 6). Many banks responded by diversifying their product offerings in order to increase non-interest income, comprised primarily of advisory services, account, credit enhancement, brokerage, and other related fees (see Exhibit 7).

This pressure also forced a massive consolidation within the banking industry over the same time period. Mergers and acquisitions reduced the number of commercial banking institutions within the U.S. from over 14,000 in the 1980's to about 7,000 (see Exhibit 8). Still, the banking industry continued to grow. The commercial banking industry held trillions in assets (see Exhibit 9). All of these changes made the FDIC's job more complex, as it had to closely monitor and regulate many different facets of the banking industry. Other agencies also aided in overseeing U.S. banking.

Another development in the early 21st century also started to have a major impact on commercial banks. Private equity funds proliferated rapidly and purchased many companies, both publicly traded and private, using high levels of debt in leveraged buyouts (LBOs). Commercial banks saw major increases in LBO related loans on their balance sheets. To limit the risk, banks packaged many of these loans into Collateralized Debt Obligations and other asset-securitization packages and sold them to other capital market investors. In addition, banks became reliant on the rapidly growing market for Credit Default Swaps (CDSs).

In 2008 a torrent of defaults in mortgage related debts looked as though it was going to destroy the U.S. banking industry. In quick order several of the largest and most prestigious investment banks went into bankruptcy or were sold at prices that represented tiny fractions of their previous values. Several of the largest U.S. commercial banks appeared on the verge of failure. The Federal Reserve and Treasury stepped in with hundreds of billions of loan guarantees, equity investments in the form of preferred stock, and liquidity guarantees. The insurance companies from whom the banks had purchased Credit Default Swaps entered bankruptcies and the government stepped in with billions more to protect the banking industry. Several large banks did fail with severe consequences to the FDIC fund and reserve ratio (see Exhibit 4). The FDIC imposed special fees on the already-weakened banking system to try to replenish the fund (see Exhibit 3).

The Federal Reserve

Established by Congress in 1913, the Federal Reserve System operated as the United States' central bank. The Federal Reserve was an independent government entity that derived its authority from the U.S. Congress, with its decisions not having to be ratified by the President or anyone else in the executive or legislative branch of government. However, the Federal Reserve was subject to oversight by Congress, which periodically reviewed its activities and altered its responsibilities by statute.

The Federal Reserve provided many services to the public, including protecting consumer credit rights and maintaining the soundness of the financial system. However, the Federal Reserve's two most visible duties were to set the nation's monetary policy and to oversee the regulation and management of banking institutions.

Monetary Policy

Monetary Policy was set by The Federal Open Market Committee (FOMC), a twelve member group of Federal Reserve System officials. The FOMC held eight regularly scheduled meetings per year. At these meetings, the Committee reviewed economic and financial conditions, determined the appropriate stance of monetary policy, and assessed the risks to its long-run goals of price stability and sustainable economic growth. The FOMC had three tools at its disposal to aid in attaining these goals:

Reserve Requirements: Reserve requirements were the amount of funds that a depository institution must hold in reserve against expected deposit liabilities. These reserves had to be in the form of vault cash or deposits with Federal Reserve Banks. When the reserve requirement was lowered, banks could loan out the difference, which effectively put more money into circulation. However, when the reserve requirement was raised, banks collected on some loans to meet this new requirement, reducing money supply.

Open Market Operations: Open market operations--the purchase and sale of U.S. Treasury and federal agency securities--were the Federal Reserve's principal tools for controlling the money supply and implementing monetary policy. These operations included targeting the federal funds

rate, the interest rate at which depository institutions lend balances at the Federal Reserve to other depository institutions overnight.

The Discount Rate: The discount rate was the interest rate charged to commercial banks and other depository institutions on loans received from their regional Federal Reserve Bank. These loans were fully secured with rates typically being set above the usual level of short-term market interest rates. Discount rates were established by each Reserve Bank's board of directors, but were generally the same across all Reserve Banks (see Exhibit 10).

Bank Regulation

In addition to setting and enforcing monetary policy, The Federal Reserve was also responsible for monitoring and regulating the operations of commercial banks and other depository institutions across the country. The following regulations, set by the Federal Reserve, had a particular impact on the FDIC:

Truth in Lending Act: The Truth in Lending Act was originally enacted by Congress in 1968 as a part of the Consumer Protection Act. The law was designed to protect consumers in credit transactions by requiring clear disclosure of key terms of the lending arrangement, as well as all costs. The law was simplified and reformed as a part the Depository Institutions Deregulations and Monetary Control Act of 1980. The Truth in Lending Act also applied to small businesses involved in consumer credit transactions or consumer leasing.

Fair Credit Reporting Act: This act was passed in 1996 and required that consumer reporting agencies (credit bureaus) adopt reasonable procedures for informing or otherwise meeting the needs of the consumer lending businesses. This included requirements that credit bureaus furnish accurate and complete information to businesses when they evaluated applications for credit, insurance, or employment.

Fair Housing Act: Title VIII of the Civil Rights Act of 1968 (Fair Housing Act) protected consumers by prohibiting discrimination in the sale, rental, and financing of homes. Under this federal regulation, equal treatment was required regardless of race, color, national origin, religion, sex, familial status and disability.

Community Reinvestment Act: The Community Reinvestment Act was enacted by Congress in 1977 and was intended to encourage banks and other depository institutions to help meet the credit needs of the communities in which they operated. This included lending to consumers in low and moderate income neighborhoods.

Home Mortgage Disclosure Act: The Home Mortgage Disclosure Act (HMDA) was enacted by Congress in 1975 and stated that public loan data could be used:

- to assist in determining whether financial institutions were serving the housing needs of their communities
- to assist public officials in distributing public-sector investments so as to attract private investment to areas where it was needed
- to aid in identifying possible discriminatory lending patterns.

Equal Credit Opportunity Act: The Equal Credit Opportunity Act (ECOA), enacted in 1978, prohibited creditors from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age, or because an applicant received income from a public assistance program.

The Office of the Comptroller of the Currency

The Office of the Comptroller of the Currency (OCC) chartered, regulated, and supervised all national banks, including the federal branches and agencies of foreign banks. Headquartered in Washington, D.C., the OCC was established in 1863 as a bureau of the U.S. Department of the Treasury. The OCC was headed by the Comptroller, who was appointed by the President. The Comptroller also served as a director of the Federal Deposit Insurance Corporation.

To ensure the safety and soundness of the national banking system, the OCC had the power to:

- Examine banks.
- Approve or deny applications for new charters, branches, capital, or other changes in corporate or banking structure.
- Take supervisory actions against banks that did not comply with laws and regulations or that otherwise engaged in unsound banking practices.
- Issue rules and regulations governing bank investments, lending, and other practices

Securities and Exchange Commission

With the stock market crash of 1929 and the ensuing depression, public confidence fell sharply and many felt the securities industry was badly in need of reform. In response to this problem, Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934. The Securities and Exchange Commission (SEC) was established in 1934 to enforce these new laws, which were formed upon two principal premises:

- Companies publicly offering securities for investment dollars must tell the public the truth about their businesses, the securities they were selling, and the risks involved in investing.
- People who sold and traded securities – brokers, dealers, and exchanges – must treat investors fairly and honestly, putting investors' interests first.

Headquartered in Washington, DC, the SEC consisted of five presidential-appointed Commissioners, four Divisions and 18 Offices. The SEC regulated and oversaw key participants in the securities world, including stock exchanges, broker-dealers, investment advisors, mutual funds, and public utility holding companies.

Office of Thrift Supervision

Formerly known as the Federal Home Loan Bank Board (FHBB), The Office of Thrift Supervision (OTS) was the primary regulator of all federally chartered and many state-chartered thrift institutions, which included savings banks and savings and loan associations.

The Federal Home Loan Bank System was created in 1932 to provide a reserve banking system for thrift institutions and the housing finance industry that would come to the rescue of beleaguered homeowners in the midst of the Great Depression. These banks were regulated by the FHBB with deposits originally insured by the Federal Savings and Loan Insurance Corporation (FSLIC).

The savings and loan industry went through many changes, primarily due to deregulatory measures instituted by the U.S. federal government, allowing them to offer a much wider range of services than ever before. Savings and loan associations began to engage in large-scale speculation, particularly in real estate. Financial failure of the institutions became rampant, with well over 500 forced to close during the 1980s. In 1989, after the FSLIC itself became insolvent, the Federal Deposit Insurance Corporation took over the FSLIC's insurance obligations, and the Resolution Trust Corporation was created to buy and sell defaulted savings and loan associations. The FHBB became the Office of Thrift Supervision, which was charged with identifying struggling savings and loan organizations before they became insolvent.

With its many existing regulatory agencies and policies, the U.S. banking system was already a complex and sensitive industry. However, with the advent of economic globalization and foreign deposits increasing as a percentage of total liabilities within the banking industry, the international Basel accords also had an impact on U.S. banking.

The BIS and the Basel Accords

The Bank for International Settlements (BIS) began operations on May 17, 1930 with the stated purpose of providing international guidance on banking policy and serving, in some capacity, as a central bank to the world's central banks, thereby facilitating the management of their foreign exchange and gold reserves.

As the banking system increasingly evolved into a global market, several issues provided impetus for standardizing international banking regulations. For one, local banks became increasingly critical of foreign banks that began competing in their countries, yet weren't subject to the same regulatory requirements. Additionally, governors of central banks became increasingly concerned about the lack of regulation around off-balance sheet transactions and financing. For example, banks were backing higher risk corporate offerings for a limited basis point spread, often referred to as backstop facilities or letters of credits. In addition, off-balance sheet derivatives had become an important product offering for most banks. Finally, the growing interdependence in the international banking community made it mutually beneficial to develop some type of universal, risk-based standard for capital adequacy requirements.

In 1974, the central bank Governors of the Group of Ten (G-10) countries began meeting in Basel, Switzerland to establish a common international standard for capital adequacy. The first Basel Accord (Basel I), published in 1987, defined capital, identified risk weights for various assets, and established a minimum reserve requirement ratio of 8% to be achieved by 1992. The capital definition divided potential capital into two tiers. Tier One, known as core capital, made up half of the minimum capital and was composed of equity capital and disclosed reserves from post-tax retained earnings. Tier Two, known as supplementary capital, could consist of

undisclosed reserves, revaluation reserves, general loan-loss reserves, hybrid debt capital instruments, subordinated term debt, and deductions from capital with various discounts and limitations. While Basel I was only required in the G-10 countries, other countries were encouraged to adopt the principles to further establish sound global banking practices.

The main drawback of Basel I was that it focused solely on the credit risk of a bank's assets when determining the base amount relative to the eight percent reserve requirement. Under this system, discounts were given for assets involving less credit risk while the highest risk assets were assessed at full value or more (see Exhibit 11). As banks implemented the system, banking officials pointed out that other components of overall risk existed aside from just credit risk. Some of these risks include operational risk, investment risk, and legal risk. In addition, wide variation existed from country to country around the supervision banks were receiving. In response to these concerns, banking representatives from the G-10 countries convened in Switzerland again in May 2003 to establish Basel II.

The second Basel Accord (Basel II) expanded upon Basel I by identifying the three pillars of international banking policy as:

- Pillar I - **minimum capital requirements**
- Pillar II - **supervisory review**
- Pillar III - **market discipline through effective disclosure**

(see Exhibit 12). Major changes to Basel I included:

- Giving supervisors intervention authority in cases related to off-balance sheet financing
- Allowing banks to include credit derivatives (swaps) as part of Tier Two capital
- Requiring banks to have reserves to address operational risks, although insurance would reduce this reserve requirement
- Relaxing disclosure requirements to more fully mirror international accounting standards
- Differentiating capital requirements for various loan categories

By 2003, Pillars I and III were already being implemented throughout the U.S. banking system, while some debate was continuing around Pillar II. Pillar I was based upon the following standard:

$$\text{Total Capital} / (\text{Credit Risk} + \text{Market Risk} + \text{Operational Risk}) = \text{Capital Ratio}$$

Each risk area would be measured by selecting a method from a menu of approaches. The minimum Capital Ratio was established at 8%.

Those in favor of Basel II (particularly in Europe) saw some potential opportunities for business performance improvement including (1) better asset selection, structuring and pricing for lending and other credit activities, (2) faster, better and cheaper underwriting processes, (3) maximizing balance sheet value through more active approaches to credit portfolio, asset-liability and capital management and product design, and (4) general process integrity and efficiency enhancements through targeted application of operational risk management techniques

Basel II also had many critics. Standard & Poor's claimed that even if banks *did* begin to increase their capital reserves to comply with Basel II, the BIS might still downgrade credit ratings on banks that they deemed to have "inadequate capital." Most banks felt that the new standards were too complicated, and some countries, like China and India, opted out entirely. Even the U.S. voiced complaints around the new definitions of capital, particularly as it pertained to capital charges for losses on bad loans. Banks already dealt with bad loans through provisions and pricing. Rules under Basel II required banks to take capital charges for expected losses as well.

While some of these issues were eventually revisited, such as the treatment of expected losses and further quantitative impact studies, Basel II continued to roll ahead. By late 2004 there had been four revisions and several extended delays to the implementation schedule. One of the later delays, in May of 2004, postponed implementation of the advanced approaches for credit risk and operational risk to the end of 2007. However, despite the continued wrangling, the new Basel Accord was released in July 2004, largely unchanged from the original draft released in May 2003. Initial implementation took place at the end of 2006.

The Basel Accords, while not fulfilling the interests of all parties involved represented a significant step forward for international banking regulation. They also represented a foundation upon which further international banking policy might proceed. However, in 2008, several large commercial banks were taken over by governments, supported by government equity infusions, or were sold under severe distress to stronger competitors. Discussions were started once again about how best to strengthen and regulate the international banking system.

Exhibit 1

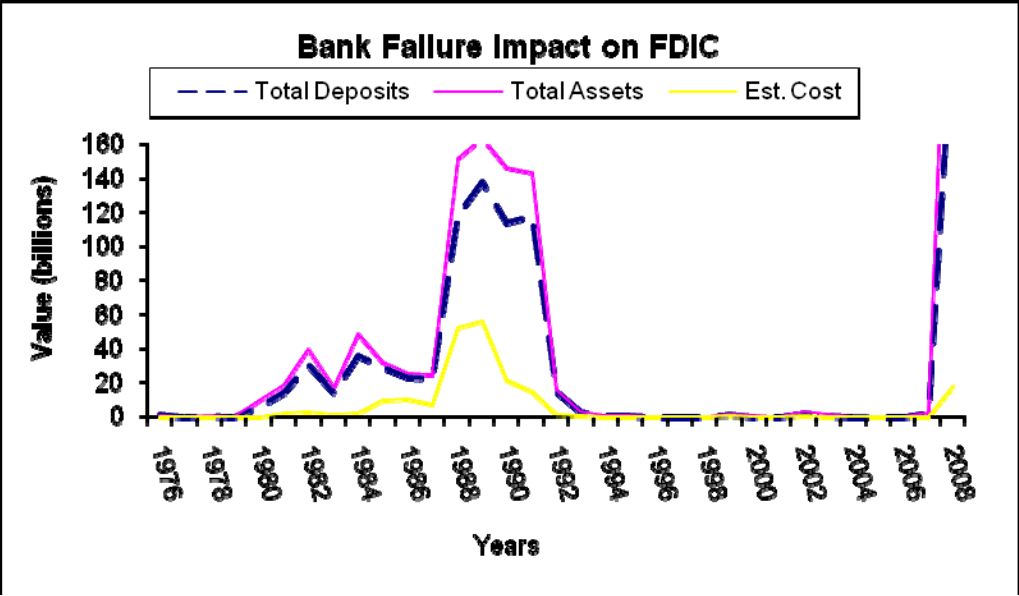


Exhibit 2

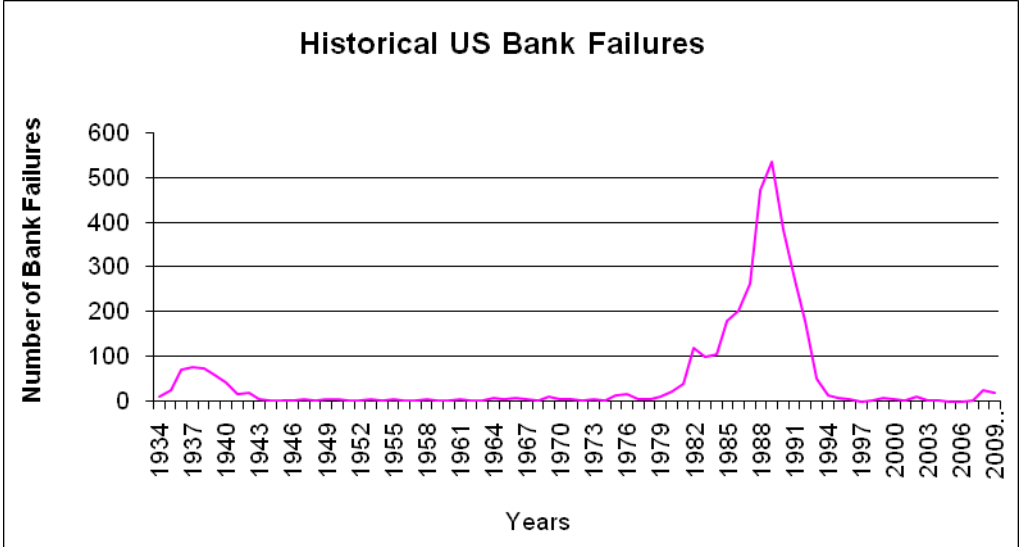


Exhibit 3 FDIC Income and Expenses (millions of dollars)

Year	Income					Expenses and Losses					
	Total Revenue	Assessment Income	Assessment Credits	Investment and Other Sources	Effective Assessment Rate	Total	Provision for Losses	Administrative and Operating Expenses	Interest and other Insur. Expenses	Net Income/(Loss)	
Total	\$104,734.0	\$58,687.4	\$8,155.0	\$52,859.7	\$0.0	\$101,753.9	\$77,667.2	\$15,611.6	\$8,481.7	\$1,980.2	
2008	7,306.3	4,410.4	1,445.9	4,341.8	0.0418%	44,339.5	41,838.8	1,033.5	1,467.2	(37,033.2)	
2007	3,196.2	642.9	-	2,553.3	0.0094%	1,090.9	95.3	992.6	3.3	2,105.3	
2006*	\$2,644.0	\$61.0	-	\$2,241.0	0.0000%	\$905.0	-\$52.0	951.0	6.0	1,739.0	
2005	1,783.0	53.0	-	1,730.0	0.0011%	711.0	(138.0)	846.0	3.0	1,072.0	
2004	1,675.4	95.3	-	1,580.1	0.0022%	558.6	(269.4)	822.4	5.6	1,116.8	
2003	1,626.0	80.2	-	1,545.8	0.0020%	(115.7)	(928.5)	805.5	7.3	1,741.7	
2002	1,795.9	84.0	-	1,711.9	0.0022%	750.6	(87.0)	821.1	16.5	1,045.3	
2001	1,996.7	47.8	-	1,948.9	0.0014%	2,559.4	1,756.3	785.9	17.2	(562.7)	
2000	1,905.9	45.1	-	1,860.8	0.0014%	645.2	(153.0)	772.9	25.3	1,260.7	
1999	1,815.6	33.3	-	1,782.3	0.0011%	1,922.0	1,168.7	730.4	22.9	(106.4)	
1998	2,000.3	21.7	-	1,978.6	0.0008%	691.5	(37.7)	697.6	31.6	1,308.8	
1997	1,615.6	24.7	-	1,590.9	0.0008%	177.3	(503.7)	605.2	75.8	1,438.3	
1996	1,655.3	72.7	-	1,582.6	0.0024%	254.6	(325.2)	505.3	74.5	1,400.7	
1995	4,089.1	2,906.9	-	1,182.2	0.1240%	483.2	(33.2)	470.6	45.8	3,605.9	
1994	6,467.0	5,590.6	-	876.4	0.2360%	(2,259.1)	(2,873.4)	423.2	191.1	8,726.1	
1993	6,430.8	5,784.3	-	646.5	0.2440%	(6,791.4)	(7,677.4)	388.5	497.5	13,222.2	
1992	6,301.5	5,587.8	-	713.7	0.2300%	(625.8)	(2,259.7)	570.8	1,063.1	6,927.4	
1991	6,790.0	5,160.5	-	629.5	0.2125%	16,862.3	15,476.2	284.1	1,102.0	(11,072.3)	
1990	3,838.3	2,855.3	-	983.0	0.1200%	13,003.3	12,133.1	219.6	650.6	(9,165.0)	
1989	3,494.6	1,885.0	-	1,609.6	0.0833%	4,346.2	3,811.3	213.9	321.0	(851.6)	
1988	3,347.7	1,773.0	-	1,574.7	0.0833%	7,588.4	6,298.3	223.9	1,066.2	(4,240.7)	
1987	3,319.4	1,696.0	-	1,623.4	0.0833%	3,270.9	2,996.9	204.9	69.4	48.5	
1986	3,260.1	1,516.9	-	1,743.2	0.0833%	2,963.7	2,827.7	180.3	(44.3)	296.4	
1985	3,385.4	1,433.4	-	1,952.0	0.0833%	1,957.9	1,569.0	179.2	209.7	1,427.5	
1984	3,099.5	1,321.5	-	1,778.0	0.0800%	1,999.2	1,633.4	151.2	214.6	1,100.3	
1983	2,628.1	1,214.9	164.0	1,577.2	0.0714%	969.9	675.1	135.7	159.1	1,658.2	
1982	2,524.6	1,108.9	96.2	1,511.9	0.0769%	999.8	126.4	129.9	743.5	1,524.8	
1981	2,074.7	1,039.0	117.1	1,152.8	0.0714%	848.1	320.4	127.2	400.5	1,226.6	
1980	1,310.4	951.9	521.1	879.6	0.0370%	83.6	(38.1)	118.2	3.5	1,226.8	
1979	1,090.4	881.0	524.6	734.0	0.0333%	95.7	(17.2)	106.8	4.1	996.7	
1978	952.1	810.1	443.1	585.1	0.0385%	148.9	36.5	103.3	9.1	803.2	
1977	837.8	731.3	411.9	518.4	0.0370%	113.6	20.8	89.3	3.5	724.2	
1976	764.9	676.1	379.6	468.4	0.0370%	212.3	28.0	180.4	3.9	552.6	
1975	689.3	641.3	362.4	410.4	0.0357%	97.5	27.6	67.7	2.2	591.8	
1974	668.1	587.4	285.4	366.1	0.0435%	159.2	97.9	59.2	2.1	508.9	
1973	561.0	529.4	283.4	315.0	0.0385%	108.2	52.5	54.4	1.3	452.8	
1972	467.0	468.8	280.3	278.5	0.0333%	59.7	10.1	49.6	6.0	407.3	
1971	415.3	417.2	241.4	239.5	0.0345%	60.3	13.4	46.9	-	355.0	
1970	382.7	369.3	210.0	223.4	0.0357%	46.0	3.8	42.2	-	336.7	
1969	335.8	364.2	220.2	191.8	0.0333%	34.5	1.0	33.5	-	301.3	
1968	295.0	334.5	202.1	162.6	0.0333%	29.1	0.1	29.0	-	265.9	
1967	263.0	303.1	182.4	142.3	0.0333%	27.3	2.9	24.4	-	235.7	
1966	241.0	284.3	172.6	129.3	0.0323%	19.9	0.1	19.8	-	221.1	
1965	214.6	260.5	158.3	112.4	0.0323%	22.9	5.2	17.7	-	191.7	
1964	197.1	238.2	145.2	104.1	0.0323%	18.4	2.9	15.5	-	178.7	
1963	181.9	220.6	136.4	97.7	0.0313%	15.1	0.7	14.4	-	166.8	
1962	161.1	203.4	126.9	84.6	0.0313%	13.8	0.1	13.7	-	147.3	
1961	147.3	188.9	115.5	73.9	0.0323%	14.8	1.6	13.2	-	132.5	
1960	144.6	180.4	100.8	65.0	0.0370%	12.5	0.1	12.4	-	132.1	
1959	136.5	178.2	99.6	57.9	0.0370%	12.1	0.2	11.9	-	124.4	
1958	126.8	166.8	93.0	53.0	0.0370%	11.6	-	11.6	-	115.2	
1957	117.3	159.3	90.2	48.2	0.0357%	9.7	0.1	9.6	-	107.6	
1956	111.9	155.5	87.3	43.7	0.0370%	9.4	0.3	9.1	-	102.5	
1955	105.8	151.5	85.4	39.7	0.0370%	9.0	0.3	8.7	-	96.8	
1954	99.7	144.2	81.8	37.3	0.0357%	7.8	0.1	7.7	-	91.9	
1953	94.2	138.7	78.5	34.0	0.0357%	7.3	0.1	7.2	-	86.9	
1952	88.6	131.0	73.7	31.3	0.0370%	7.8	0.8	7.0	-	80.8	
1951	83.5	124.3	70.0	29.2	0.0370%	6.6	-	6.6	-	76.9	
1950	84.8	122.9	68.7	30.6	0.0370%	7.8	1.4	6.4	-	77.0	
1949	151.1	122.7	-	28.4	0.0833%	6.4	0.3	6.1	-	144.7	
1948	145.6	119.3	-	26.3	0.0833%	7.0	0.7	6.3	-	138.6	
1947	157.5	114.4	-	43.1	0.0833%	9.9	0.1	9.8	-	147.6	
1946	130.7	107.0	-	23.7	0.0833%	10.0	0.1	9.9	-	120.7	
1945	121.0	93.7	-	27.3	0.0833%	9.4	0.1	9.3	-	111.6	
1944	99.3	80.9	-	18.4	0.0833%	9.3	0.1	9.2	-	90.0	
1943	86.6	70.0	-	16.6	0.0833%	9.8	0.2	9.6	-	76.8	
1942	69.1	56.5	-	12.6	0.0833%	10.1	0.5	9.6	-	59.0	
1941	62.0	51.4	-	10.6	0.0833%	10.1	0.6	9.5	-	51.9	
1940	55.9	46.2	-	9.7	0.0833%	12.9	3.5	9.4	-	43.0	
1939	51.2	40.7	-	10.5	0.0833%	16.4	7.2	9.2	-	34.8	
1938	47.7	38.3	-	9.4	0.0833%	11.3	2.5	8.8	-	36.4	
1937	48.2	38.8	-	9.4	0.0833%	12.2	3.7	8.5	-	36.0	
1936	43.8	35.6	-	8.2	0.0833%	10.9	2.6	8.3	-	32.9	
1935	20.8	11.5	-	9.4	0.0833%	11.3	2.8	8.5	-	9.5	
1933/4	7.0	-	-	7.0	N/A	10.0	0.2	9.8	-	(3.0)	

Source: www.fdic.gov - About FDIC - financial reports - annual reports and CFO report to the board

* Starting in 2006 the Federal Reserve merged the BIF and the SAIF into one reporting unit

Exhibit 4

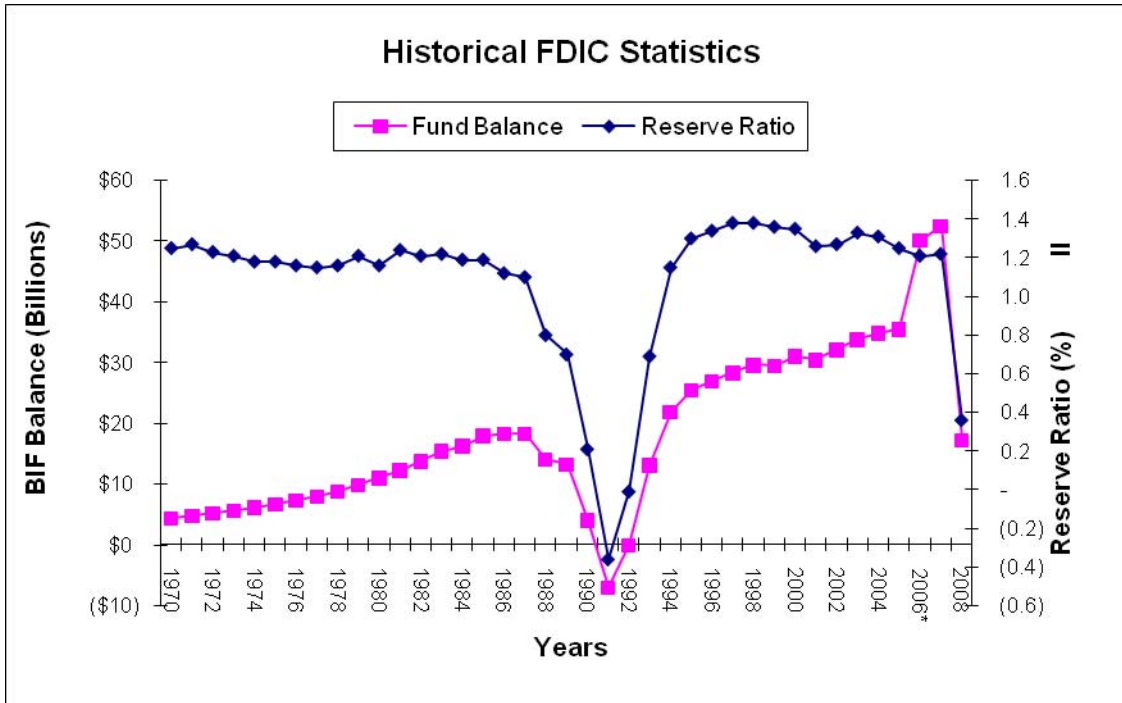


Exhibit 5

Assessment Rate Schedule and FICO Rates

BIF & SAIF-Insured Institutions			
	Supervisory Subgroup		
Capital Group	A	B	C
1. Well	5-7 bp	10 bp	28 bp
2. Adequate	10 bp	10 bp	28 bp
3. Under	28 bp	28 bp	43 bp

Effective January 1, 2007

Note: Basis points (bp) is cents per \$100 of assessable deposits (annual rate).

Supervisory Subgroups

Subgroup A - This subgroup consists of financially sound institutions with only a few minor weaknesses and generally corresponds to the primary federal regulator's composite rating of "1" or "2."

Subgroup B - This subgroup consists of institutions that demonstrate weaknesses which, if not corrected, could result in significant deterioration of the institution and increased risk of loss to the BIF or SAIF. This subgroup assignment generally corresponds to the primary federal regulator's composite rating of "3."

Subgroup C - This subgroup consists of institutions that pose a substantial probability of loss to the BIF or the SAIF unless effective corrective action is taken. This subgroup assignment generally corresponds to the primary federal regulator's composite rating of "4" or "5."

Capital Groups

Group 1 - "Well Capitalized." Total Risk-Based Capital Ratio equal to or greater than 10 percent, and Tier 1 Risk-Based Capital Ratio equal to or greater than 6 percent, and Tier 1 Leverage Capital Ratio equal to or greater than 5 percent.

Group 2 - "Adequately Capitalized." Not Well Capitalized and Total Risk-Based Capital Ratio equal to or greater than 8 percent, and Tier 1 Risk-Based Capital Ratio equal to or greater than 4 percent, and Tier 1 Leverage Capital Ratio equal to or greater than 4 percent.

Group 3 - "Undercapitalized." Neither Well Capitalized nor Adequately Capitalized.

Exhibit 6

Commercial and Industrial Loans as a % of Corporate Bonds

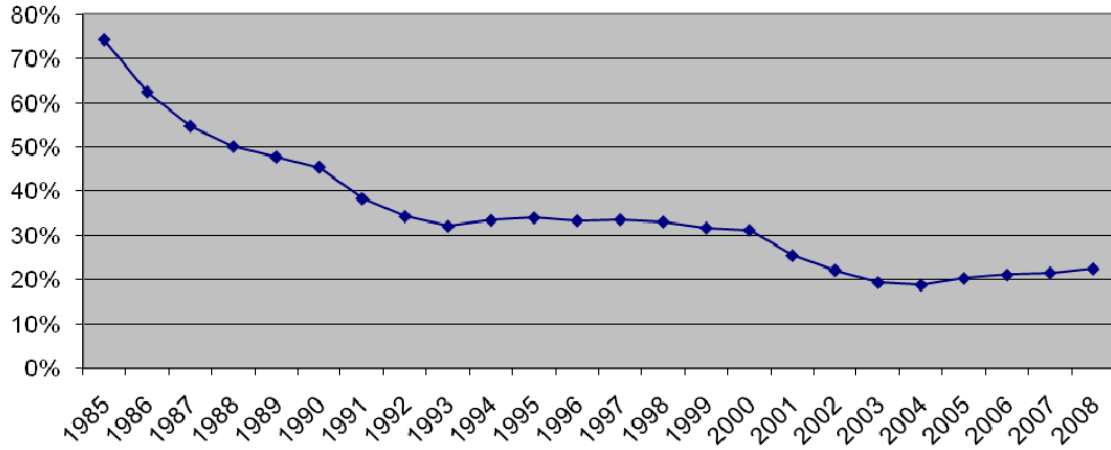


Exhibit 7

Historical Bank Income

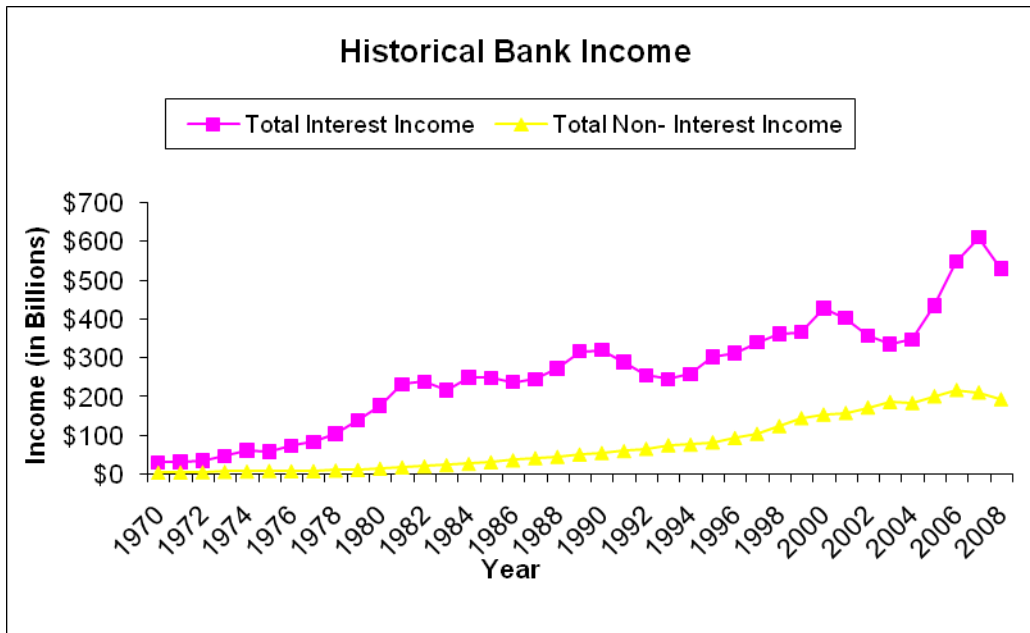


Exhibit 8

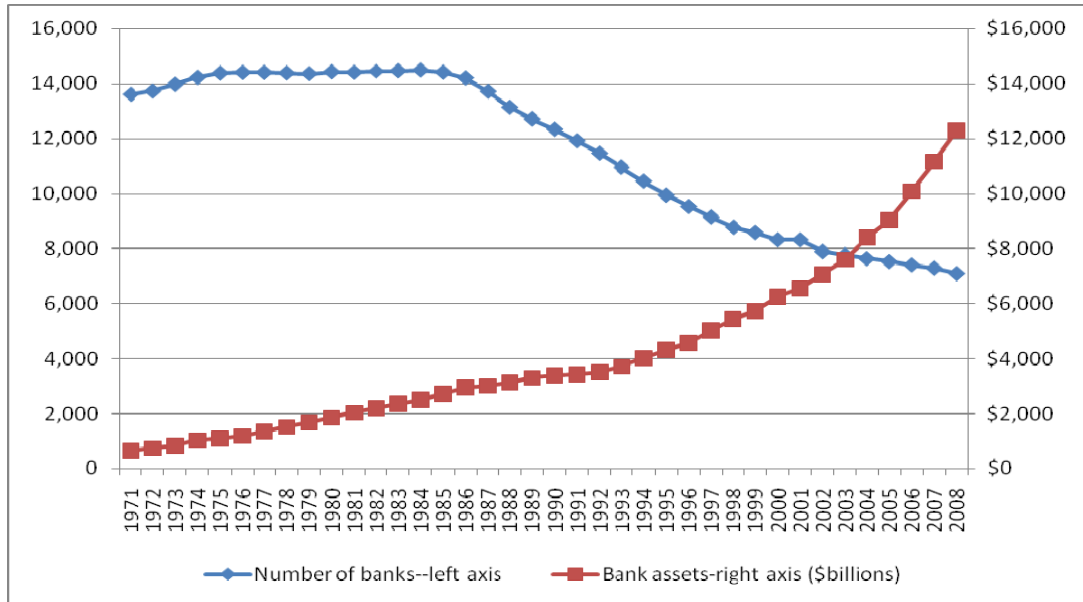


Exhibit 9

Aggregate Banking Industry Balance Sheet
(in Thousands)

ASSETS	2008	2007	2006	2005
Cash	\$ 1,041,776,259	\$ 482,193,325	\$ 432,032,217	\$ 400,187,526
Investment Securities	1,746,538,869	1,590,802,437	1,665,727,775	1,572,270,252
Total Loans and Leases	6,839,998,175	6,626,395,415	5,980,643,604	5,380,050,639
Allowance for Losses on Loans and Leases	<u>(156,151,745)</u>	<u>(88,993,416)</u>	<u>(69,094,717)</u>	<u>(68,671,186)</u>
Net Loans and Leases	6,683,846,430	6,537,401,999	5,911,548,887	5,311,379,453
Other Earning Assets	1,652,882,923	1,513,662,959	1,149,617,721	942,539,863
Bank Premises and Equipment	109,659,323	105,017,384	96,802,146	91,706,910
Other Real Estate	22,974,160	9,785,066	5,469,980	4,026,084
Intangible Assets	393,927,584	423,217,982	358,517,993	302,935,338
All Other Assets	<u>661,308,732</u>	<u>514,074,232</u>	<u>470,705,589</u>	<u>414,339,575</u>
Total Assets	\$ 12,312,914,280	11,176,155,384	10,090,422,308	9,039,385,001
LIABILITIES				
Total Deposits	8,082,103,817	7,309,810,091	6,731,368,688	6,073,106,864
Borrowed Funds	2,079,093,908	1,880,555,391	1,589,238,341	1,423,425,343
Subordinated Notes	182,987,299	174,904,850	149,794,691	122,236,763
Other Liabilities	<u>\$ 811,080,968</u>	<u>667,871,865</u>	<u>589,841,385</u>	<u>508,164,581</u>
Total Liabilities	11,155,265,992	10,033,142,197	9,060,243,105	8,126,933,551
EQUITY				
Perpetual Preferred Stock	6,430,909	5,003,917	5,129,661	5,272,135
Common Stock	45,516,163	35,987,418	33,949,521	32,334,630
Surplus	850,962,270	738,863,073	625,410,032	529,652,071
Undivided Profits	254,738,920	363,158,775	365,689,989	345,192,589
Other Capital	--	--	--	--
Total Equity Capital	<u>1,157,648,262</u>	<u>1,143,013,183</u>	<u>1,030,179,203</u>	<u>912,451,425</u>
Total Liabilities and Equity	12,312,914,254	\$ 11,176,155,380	\$ 10,090,422,308	\$ 9,039,384,976

Exhibit 9 (Cont.)

Aggregate Banking Industry Income Statement (in thousands)

	2008	2007	2006	2005
Interest Income	\$ 530,513,220	\$ 611,184,710	\$ 547,953,885	\$ 434,500,683
Interest Expense	<u>210,569,225</u>	<u>307,962,649</u>	<u>263,058,529</u>	<u>165,143,426</u>
Net Interest Income	\$ 319,943,995	\$ 303,222,061	\$ 284,895,356	\$ 269,357,257
Total Non Interest Income	193,853,404	210,999,491	217,394,028	201,328,341
Total Non Interest Expense	329,049,991	314,075,361	290,210,724	276,239,191
Provision for Loan and Lease Losses	<u>151,244,430</u>	<u>28,153,221</u>	<u>25,503,027</u>	<u>26,606,944</u>
Pre Tax Net Operating Income	33,502,978	171,992,970	186,575,633	167,839,463
Securities Gains/Losses	(14,065,842)	(642,325)	(1,348,208)	(157,850)
Applicable Income Taxes	6,163,352	42,812,993	59,504,906	53,887,839
Net Extraordinary Items	<u>5,452,298</u>	<u>(1,740,870)</u>	<u>2,642,641</u>	<u>240,627</u>
Net Income	\$ 18,726,082	\$ 126,796,782	\$ 128,365,160	\$ 114,034,401

Exhibit 10

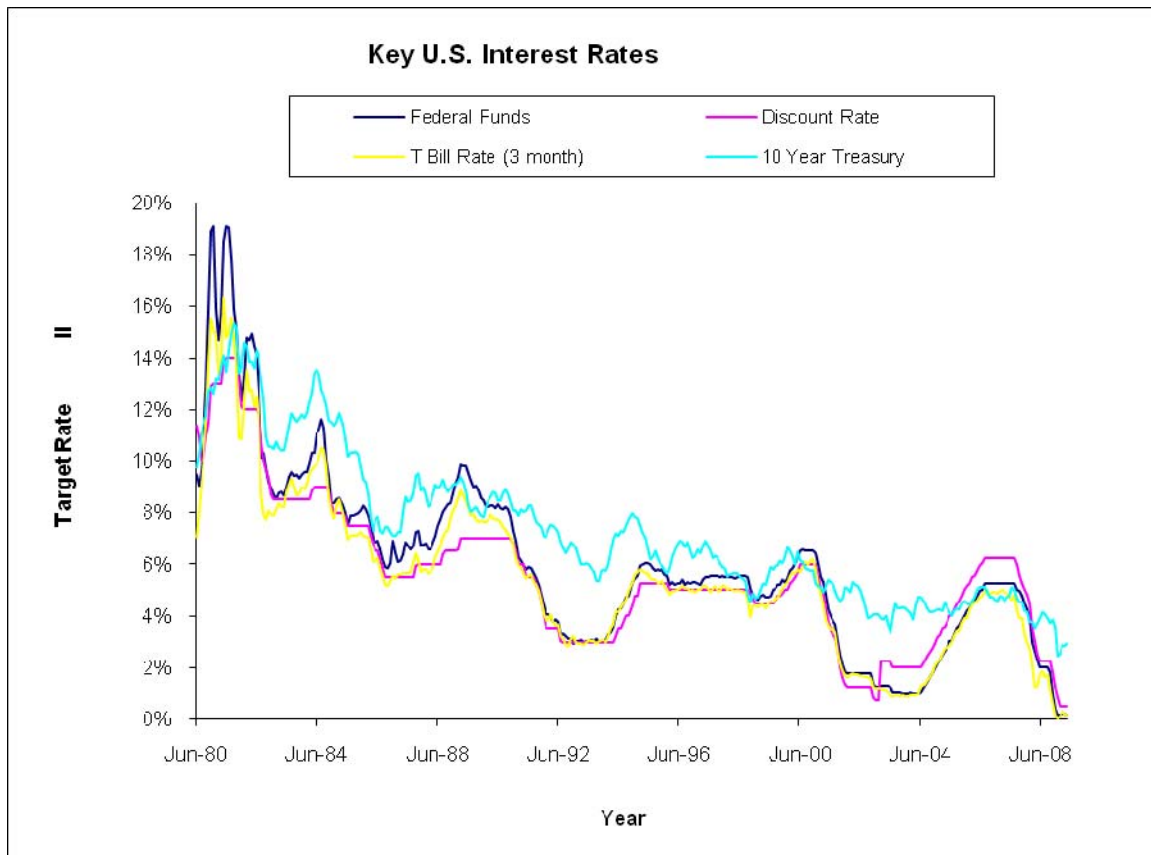


Exhibit 11

Financing Activity	Balance Sheet	Risk Weighting	Required Capital (in millions)	
\$100M AAA rated loan	on	20%	\$	1.60
\$100M A- rated loan	on	50%	\$	4.00
\$100M BBB rated loan	on	100%	\$	8.00
\$100M CCC rated loan	on	150%	\$	12.00
\$100M Unrated loan	on	199%	\$	8.00
\$100M Loans in Default	on	150%	\$	12.00
\$100M Backstop facility	off	0 to 50%	\$	0 to 4
\$100M Interest Rate Swap (1-year)	off	0%	\$	-
\$100M Interest Rate Swap (7-year)	off	1.5%	\$	0.12
\$100M Exchange Rate Swap (50year)	off	5.0%	\$	0.40

BIS Risk Weighting Information (1995)

Exhibit 12

Basel Objectives	What it Means to Commercial Banks
Pillar I - Regulatory Capital Charge	Risk Framework
	Governance/Oversight Structure
	Common Risk Language
	Risk Monitoring/Measurement Tools and Methodologies
	Validation & Back testing Techniques
	Risk Databases
	Pillar II - Supervisory Oversight
Credit	
Market	
Enterprise-Wide Mgt. Reporting Database	
Risk Modeling & Quantification	
Risk Adjusted Performance Measurement & Economic Capital	
Early Warning Indicators	
Pillar III - Market Discipline	Reports to Meet Disclosure Requirements

Basel II: What does it mean to U.S. Bank--Ernst & Young 2003