



Regulatory Proposals

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Focus: Regulatory Proposals

About this Publication

If it seems like the number of regulations and guidance letters that bankers need to study and adhere to keeps expanding, that's because they probably have! Yet, regulators give constant attention to potential burden implications of each new proposal (really!) and progress has been made to reduce burden under the Economic Growth and Regulatory Paperwork Reduction Act (see <http://www.egrpra.gov/WhatWeDoing.html>). What's driving the new regulations, guidance, and proposals?

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REGULATORY PROPOSAL

CRE Loan Concentration Guidance



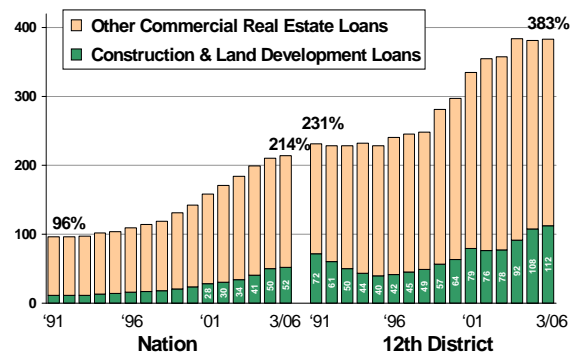
In January 2006, U.S. bank supervisors issued proposed guidance on managing commercial real estate “CRE” lending concentrations. Bankers have voiced concerns about the proposal on a number of fronts. In this article, we'll provide a brief background and try to clarify a few elements of the proposal.

Background: U.S. bank supervisors issued the proposed guidance because of concerns with growing CRE loan concentrations, particularly at small to medium-sized institutions. On average, CRE loans account for 63 percent of total loans at western banks, up from 32 percent in 1991. Construction & land development loans are included in the CRE totals, and these average 18 percent of loans, up from 10 percent in 1991 (CRE loan trends as a percentage of capital are shown in the chart at left). Historically, CRE lending has been a volatile asset class for banks, playing a central role in the banking problems in late 1980s and early 1990s. While underwriting standards are generally stronger than they were back then, benign credit conditions have contributed to recent loosening of underwriting terms. Additionally, bank supervisors are concerned that risk management practices and capital levels at some institutions have not kept pace with the rapid growth in CRE exposures.

Proposal: Banks with high CRE loan concentrations, determined in part through comparisons to two benchmark levels established in the proposal (construction & land development loans exceeding 100 percent of total capital; total CRE loans exceeding 300 percent of capital) are expected to have risk management processes and capital commensurate with the level and nature of concentration risk.

Discussion: The proposed guidance largely reinforces existing guidance related to real estate lending and management of loan concentrations. The intent of the proposed “threshold” percentages is not to limit or otherwise restrict banks' participation in the CRE sector. Rather, the thresholds should be viewed as “benchmarks” to serve as a

Average Bank CRE Loan Concentration Ratios* Near Record Levels!



*Adjusted average ratios as a percent of Tier 1 capital + ALLL; commercial banks only; CRE loans exclude farmland-secured; Source: Bank Call Reports

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For the most part, they're precipitated by new banking risks and products, and occasionally they come from Congress or other rule setting bodies, like the Basel Committee on Banking and the FASB.

Since we cannot flip a switch and reduce regulatory burden, we'll at least try to highlight key aspects of several current regulatory issues here, and we'll touch upon a few other banking risk areas that are "on our radar screen".

starting point for analysis of the nature and extent of a loan concentration. In fact, as proposed, the total CRE loan benchmark already excludes all "owner occupied" commercial mortgage loans where the primary source of repayment is the cash flow from a business. Examiners will be able to consider other factors as well before determining if a concentration exists (e.g. residential construction loans that are pre-sold might be excluded).

Of course, there are a wide variety of CRE loan types included in the benchmark ratios, and these different loan types have varying risk characteristics. Some bankers have questioned whether it is appropriate to add these different loan types together when determining whether a CRE concentration exists. However, a review of historical data shows that the major classes of CRE loans and the major commercial property types perform similarly over economic cycles (e.g. see slide on nationwide property values). This is particularly evident during cyclical troughs when property values generally fall and credit losses rise across all sectors. In addition, annual appreciation rates are positively correlated with over 40% correlation rates between sectors nationwide over the past 20 years, and within some MSAs, the correlation rates are much higher. The banking agencies believe that the generally correlated performance of CRE loans over economic cycles supports the inclusion of aggregate CRE loan benchmarks in the proposal.

More than half the commercial banks in the West are likely to exceed one or both benchmarks, so many may have concerns about how the guidance will be applied. In general, we anticipate relatively little change in examination processes. Bank supervisors in the West have been monitoring growing concentrations for years, and for the past two years have communicated heightened expectations to banks with regard to concentration risk management practices. These expectations (current and proposed) are consistent with past guidance. Basically, the new proposal brings together previously published guidance into one document to focus attention on CRE concentration management at a time when conditions are good and bank capitalization is generally strong. The proposal serves as a reminder to banking organizations' boards of directors and management that 1) it is their ultimate responsibility to approve the level of risk assumed, and 2) appropriate risk management and capital are essential elements of a sound CRE lending strategy. Some banks may be concerned about the linkage of CRE concentrations with capital levels, but this should not represent a significant change. The adequacy of a bank's capital has always been evaluated by examiners on a case-by-case basis, based on a thorough analysis of the inherent risks and risk management practices of each bank. Currently, most institutions with CRE concentrations already hold capital well in excess of regulatory minimums and have many of the suggested risk management elements in place. Therefore, these institutions may not need to adjust their practices to adhere to the proposal.

Status: Public comments are currently under review by the Agencies.

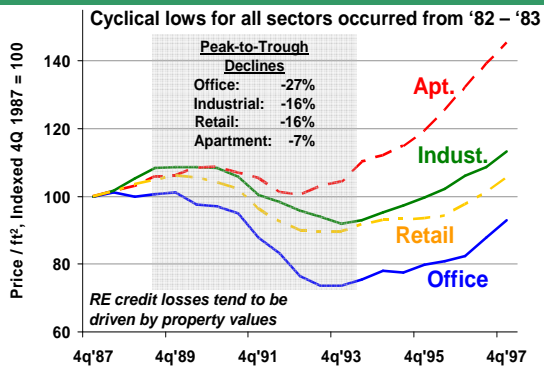
RADAR SCREEN BLIP

A Slowing Housing Market: Time to Review C&LD Loan Underwriting Standards?



As can be seen from the CRE loan concentration chart on page 1, construction & development (C&LD) loans have grown sharply in recent years, now averaging 112 percent of capital at western banks. Additionally, ten percent of western banks now have C&LD concentration ratios above 290 percent. A large portion of the recent growth represents loans on 1-4 family residential land, development and

Nationwide Property Values



Source: National Real Estate Index Market History Data

construction, which should not be surprising given the strength of the housing market in recent years. With the long-anticipated slowing of the housing market apparently upon us (sales declining, inventories rising), it may be time for managers to take steps to scrutinize and limit their risks in riskier segments of residential C&LD lending. Even if the most likely outcome is a moderate housing slowdown and no significant home price declines, bankers might consider the small possibility that there could be a significant housing correction over an extended period. In this type of market, the greatest risk to bankers is in the riskier segments: loans for land acquisition and for speculative development and construction. Historically, these are the first to register the effects of a slowdown both in terms of slowing demand for new loans and weakening quality of existing loans. A proactive banker could consider how a housing slowdown and resulting decline in loan demand might impact the bank's budget and projections. Additionally, a slowing market could result in events that expose lenders to possible credit losses, such as project delays, houses that fail to sell, and the need for price discounts. Proactive managers could more closely monitor progress on funded/committed higher-risk projects. They could also reconsider existing underwriting standards for new extensions, such as amount of required borrower cash equity and collateral coverage requirements (LTVs), and they could review internal lending limits on new extensions, in particular in these lending areas:

- » Land acquisition
- » Speculative (non-owner occupied) land development and construction
- » Unsecured loans to developers
- » C&LD loans in popular investment markets such as Bakersfield, Boise, Fresno, Las Vegas, Medford/Ashland, Phoenix, Redding, and Reno, which may be more vulnerable to price corrections

Managers might also consider measuring the sensitivity of their C&LD portfolio to adverse housing market conditions. For example, how might diminished loan demand, funded project delays, cost overruns, and/or collateral value declines impact a bank's budget, loss reserves, earnings and capital? Such analysis could help bankers determine if they are comfortable with current exposure levels.

REGULATORY PROPOSAL

“Basel IA” — What’s It All About?



Adopted in 1989, the U.S. risk-based capital standards are based primarily on the 1988 Capital Accord (commonly referred to as Basel I) developed by the Basel Committee on Banking Supervision. While the Basel I rule was designed to apply only to internationally active banks, the U.S. banking agencies chose to apply the framework to U.S. bank holding companies exceeding a certain asset threshold and all insured depository institutions.

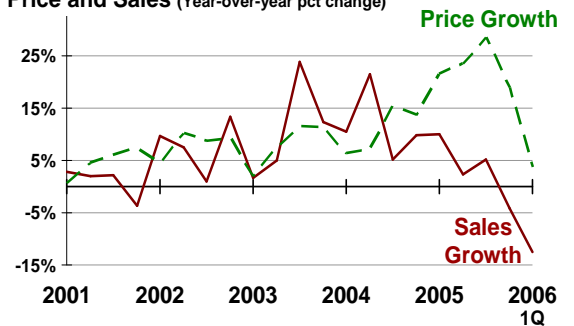
The U.S. banking agencies have decided that only the very largest or the internationally active banking organizations will be required to adopt the most advanced credit and operational risk approaches articulated in the Basel II framework, while other qualified institutions are permitted to opt in on a voluntary basis. That means that, aside from these “Basel II” institutions, the majority of banking institutions will remain subject to the current capital standards and the banking industry will operate under a bifurcated capital regime.

Last year, the banking agencies issued a proposal to revise the current risk-based capital standards (the proposal is commonly referred to as Basel IA). The purpose is

(Continued on page 4)

Housing Slow-Down Underway

Western Region Existing Homes Median Price and Sales (Year-over-year pct change)



Source: National Association of Realtors



“The purpose is to ensure that the capital framework remains relevant... while minimizing potential competitive equity differences in capital requirements...between Basel II and non-Basel II banks, and maintaining an operationally feasible capital framework that is simple to implement.”



RADAR SCREEN BLIP

Lessons Learned From Hurricane Katrina

According to the new FFIEC/CSBS informational booklet “Lessons Learned from Hurricane Katrina¹”, the most important things for institutions preparing for/responding to a catastrophic event are:

- » Location, Location, Location! Increase the distance between core facilities and back-up sites — this may be critical to a successful recovery effort.
- » Anticipate potentially extensive destruction and a prolonged recovery period.
- » Be prepared to operate in a “cash only” environment.
- » Stock-up on supplies ranging from essential human necessities such as water, food and medicine to critical business forms — they may be difficult to obtain during a prolonged recovery.

¹ See http://www.ffiec.gov/katrina_lessons.htm.

to ensure that the capital framework remains relevant and reliable for the banking system, while minimizing potential competitive equity differences in capital requirements that may arise between Basel II and non-Basel II banks, and maintaining an operationally feasible capital framework that is simple to implement.

Highlights of the proposed changes in the Basel IA proposal include increasing the number of risk weighting categories, expanding the use of credit ratings to determine exposures’ risk weight, expanding eligible financial collateral and guarantors, and requiring higher capital requirements for certain riskier types of assets such as acquisition, development and construction loans. Since one of the most debated policy issues is the potential competitive imbalances between the Basel II and the non-Basel II banks, the agencies also propose changes to the current rule to address the competitive equity issue. For example, the proposal plans to lower the risk weights for certain small business loans, and outlines two possible options for determining the capital requirements for residential mortgages rather than using the flat 50 percent risk weight under existing standard. The proposal does not identify changes to the U.S. leverage ratio requirement articulated in the Prompt Corrective Action legislation.

Based on the 70 or so comment letters, it appears that the banking industry is divided about the proposal as the comments received are quite varied. A number of banking organizations have supported the creation of a more risk sensitive capital framework for the non-Basel II institutions for competitive equity reasons, while others have expressed the concern that the revised rule could create unnecessary regulatory burden at a time when the current capital standards are working well for them. Some have suggested that there should be an asset threshold below which banks should be allowed to remain on Basel I.

At this time, the banking agencies have completed the review of the comments and are expecting to issue a final proposal later this summer or in the early fall around the same time as the Basel II proposal. Following publication in the Federal Register, there will be a 4-month comment period.

ACCOUNTING PROPOSAL

Recent FASB Fair Value Accounting Proposals

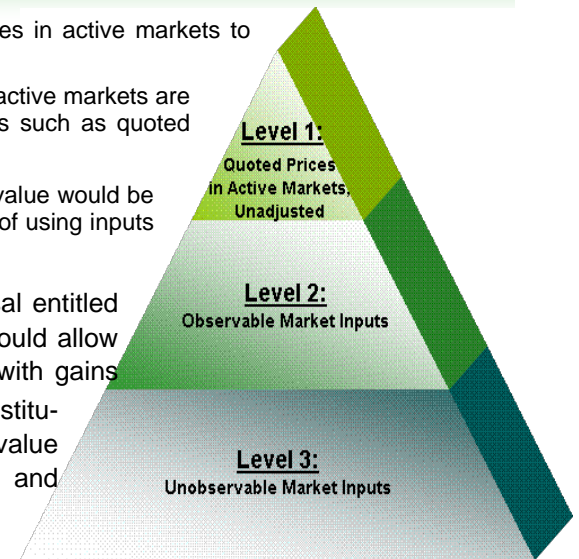


In recent years, proponents of fair value accounting have argued that reporting assets and liabilities at fair value would enhance the transparency of financial statements and provide a more relevant representation of a company’s financial condition. These supporters believe that the current mixed-attribute measurement model, in which some assets are measured at fair value while most liabilities are measured at historical cost, is not adequate for today’s complex risk management strategies.

As a result, both U.S. and international accounting standard setters have adopted longer-term objectives of expanding the usage of fair value accounting. This article provides an update on the progress toward adopting fair value accounting by the U.S. Financial Accounting Standards Board (FASB). We focus on the status of the two proposed standards -- “fair value measurement” and “fair value option.” Lastly, the article discusses the banking industry’s and the banking agencies’ comments on the FASB’s recent fair value option proposal.

Fair Value Measurement: In June 2004, the FASB issued a draft proposal entitled *Fair Value Measurements* that provides guidance on how to measure fair value. This guidance does not expand the use of fair value beyond the assets and liabilities currently subject to fair value measurement. In essence, the proposed guidance would establish a three-level hierarchy for estimating fair value:

- » Level 1 Value Estimates: Use quoted prices for identical assets and liabilities in active markets to estimate fair value.
- » Level 2 Value Estimates: If quoted prices for identical assets and liabilities in active markets are not available, fair value would be estimated using observable market inputs such as quoted prices for similar assets and liabilities.
- » Level 3 Value Estimates: If Level 1 or Level 2 estimates are unavailable, fair value would be estimated using unobservable market inputs (e.g. to emphasize the concept of using inputs that a market participant would use if a market existed).



Fair Value Option: In January 2006, the FASB issued another proposal entitled *The Fair Value Option for Financial Assets and Financial Liabilities* that would allow most financial assets and financial liabilities to be recorded at fair value, with gains and losses from changes in fair value recorded in earnings. Any financial institution could decide to adopt this valuation option. The election to report fair value would be available on an instrument-by-instrument basis, is irrevocable, and generally must occur at the time the instrument is entered into.

The FASB believes that allowing this option will address the problems associated with the mixed-attribute model and will make it easier for companies to accomplish the benefits of hedge accounting. Perhaps the most controversial aspect of this fair value option proposal is to allow the possibility for entities to “mark-to-market” their own credit risk. If an entity’s creditworthiness deteriorates, financial liabilities would be marked down to fair value and a gain would be recorded in the entity’s profit and loss statement. In the most dramatic case, an insolvent entity might appear solvent as a result of marking to market its own deteriorated credit risk.

Banking Industry’s Reaction to the Proposal: The banking industry’s reaction to fair value accounting has been divided. Some leading financial institutions such as Citigroup, JP Morgan Chase, and Goldman Sachs have voiced strong support for the fair value option proposal. In addition, the Mortgage Bankers Association indicated that it “agrees wholeheartedly with the board that the fair value option will improve financial reporting”. However, not everyone in the industry is as thrilled about the proposal. The American Bankers Association raised its objection and even noted that some members’ support was motivated by a desire to repair some of the current problems associated with the accounting standards for derivatives and hedging.

Federal Reserve’s View on Fair Value Accounting: The Federal Reserve took the position that the fair value measurement proposals are good first steps toward enhancing fair value measurement guidance. However, some important issues warrant further consideration before the FASB proceeds with a more broad adoption of fair value accounting. In particular, the Fed is very concerned with the reliability and verifiability of fair value accounting measures. The majority of bank assets and liabilities do not have an active market, so fair value estimates would have to rely primarily on Level 3 and Level 2 estimates, which could vary significantly and be very subjective. For example, while it might make sense for certain assets such as traded financial instruments to be measured at fair value, many financial assets and liabilities at banks, such as non-traded, illiquid financial instruments, cannot be reliably measured. Therefore, in the fair value option comment letter sent to the FASB by the five banking agencies, they strongly recommended that the fair value option be permitted only for those financial instruments for which a reliable measure can be made. This would reduce the subjective nature of the valuations, and the possibility for management bias. Finally, the FASB also is encouraged to conduct further research and testing to evaluate the concerns pertaining to fair value accounting before significantly expanding the use of fair value in the financial statements.

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“The majority of bank assets and liabilities do not have an active market, so fair value estimates...could vary significantly and be highly subjective.”



12th Federal Reserve District

In summary, these mixed views presented by the constituents may signal an even more contentious debate ahead as the FASB is contemplating finalizing the two proposals after reviewing all the comment letters.

REGULATORY PROPOSAL

Nontraditional Mortgage Guidance



In December 2005, U.S. bank supervisors issued proposed guidance on nontraditional mortgage products. While most of the nontraditional mortgage products addressed in the proposal have been available for years, they were specifically targeted to niche markets and sophisticated borrowers as flexible financial instruments tailored for individual purposes. In the past few years consumer demand has been growing, particularly in high priced real estate markets and nontraditional mortgage products are now offered to a wider spectrum of borrowers resulting in explosive growth at a time when there are other risk factors (e.g., rising interest rates, declining asset appreciation, etc.) present. This article provides a brief background and discussion on the proposal.

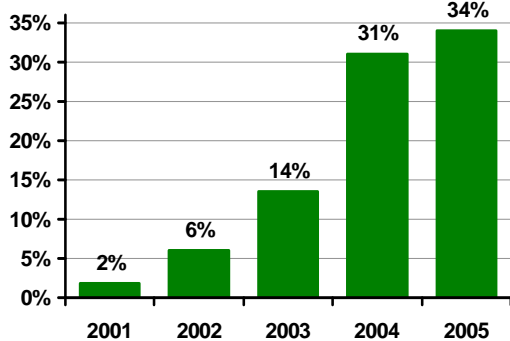
Background: While there is no standard definition for non-traditional mortgages, loans with the following characteristics would typically fall within the category: interest only, interest deferral, negative amortization, limited loan documentation, stated income, etc. Recently, many of these loans have surged in popularity. In 2005, option ARMs and Interest Only (IO) loans comprised an estimated one-third of total U.S. mortgage originations, up from a negligible proportion in 2001. In California, IO origination volume has recently been closer to 40 percent of the total. These and other nontraditional mortgage products have increasingly been offered by lenders along with reduced verification requirements and simultaneous second-liens. Regulators believe that these risk-layering practices expose financial institutions to increased risk.

Proposal: Institutions offering nontraditional mortgage products should ensure that their underwriting practices address the additional risks they may be exposed to. They should also have portfolio and risk management practices that keep pace with the growth of their nontraditional mortgage products. Finally, in offering these products, they should ensure compliance with applicable consumer protection laws and regulations.

Discussion: Nontraditional mortgage products offer payment flexibility which can be very effective and beneficial for some borrowers. However, these products (e.g. IO, etc.), developed largely for financially sophisticated borrowers with special circumstances, have proliferated among mainstream and subprime borrowers who may not have otherwise qualified for traditional mortgages. Banking supervisors are concerned that some of these borrowers will not sufficiently understand product terms or be able to manage payment shocks likely to occur when initial low payment periods end. Payment-option borrowers have tended to select the minimum payment option as interest rates have increased, typically resulting in negative amortization, and these borrowers face substantial payment increases over time. The proposed guidance suggests that prudent underwriting practices, including underwriting loans at the fully amortizing rate, should be embedded within the risk management process. It suggests mitigating factors such as higher credit scores, lower LTV and DTI ratios, or other credit enhancements should be present when risks are layered.

In addition to safety and soundness concerns, nontraditional mortgage products potentially increase legal and reputational risks to lenders. The proposed guidance stresses the importance of lenders providing consumers with information designed to

Interest Only Loan Originations as a Percentage of Total Originations*, Nationwide



* Dollar volume of non-agency originations each year.
Source: LoanPerformance.

help them make informed decisions when selecting and using these products. The guidance offers recommended practices with respect to disclosures, marketing, and avoidance of obscuring information or unwarranted practices.

One aspect of the proposed guidance receiving attention is the potential uneven playing field with non-regulated competitors. Supervisors believe that regulated institutions can achieve an appropriate balance between heightened risk management practices and remaining competitive in the marketplace, and that these two areas are not considered mutually exclusive.

Status: Public comments are currently under review by the Agencies. The final guidance should be issued later this year.

REGULATORY REVISION

Is CRA's New Intermediate Small Bank Test Right for Your Bank?



In mid-2005, the bank regulatory agencies approved revisions to the Community Reinvestment Act (CRA) examination process intended to reduce regulatory burden for certain financial institutions. Under the revised rule, banks with total assets between \$250 million and \$1 billion, formerly considered large banks (LB), have the option of being examined as intermediate small banks (ISB). These institutions are no longer required to collect and report CRA loan data, considered to be one of the most burdensome aspects of the LB test. In addition, the ISB examination was restructured to offer more flexibility. Rather than separate lending, investment, and service tests, institutions are examined under a lending test and a community development (CD) test that includes all CD activities. Many bankers within this asset range welcomed the reduced burden and rushed to classify their institutions as ISBs. Some banks, however, may not have considered all of the implications of making the switch. Prior to making the change, bankers should recognize the differences between the two evaluation methodologies. Specifically, a large bank's rating is determined based on a scoring system that is outlined in [CRA Q&A](#). In order to achieve a satisfactory rating, a bank must achieve a minimum total score of 11 points. Depending on the strength of the performance in each test, it is possible to achieve an overall satisfactory rating with a rating of needs-to-improve in one or more tests. For example, a high satisfactory rating on the lending test is worth 9 points. If a bank was rated high satisfactory on the lending test, it could receive a rating of needs-to-improve on both the investment and service tests – worth 1 point each – and still receive 11 points for an overall satisfactory rating. Under the ISB test, however, a bank is required to receive a satisfactory rating on both the lending and CD tests in order to receive an overall satisfactory rating. As a result, it is possible that an ISB with similar performance may not receive an overall satisfactory rating.

Further, the movement of all CD activities to the CD test could also have an impact on a bank's overall rating. How? Under the large bank test, CD loans are evaluated under the lending test. As a result, if a large bank has difficulty achieving satisfactory performance through direct small business or mortgage lending, it is possible to enhance performance through strong CD lending. But, because CD loans are evaluated under the CD test for ISBs, the same is not true for them. As an ISB, CD lending may contribute to an overall outstanding rating on the CD test, but the institution will receive a less-than-satisfactory overall rating if its direct lending performance is inadequate.

So what should a bank do to ensure that there are no surprises at the next exam? Prior to deciding that ISB is the right choice, a bank should conduct an assessment of its CRA performance and evaluate strengths and weaknesses relative to each testing methodology. The test chosen may just make a difference in the bank's overall CRA rating.



“Many bankers within this asset range welcomed the reduced burden and rushed to classify their institutions as Intermediate Small Banks. Some banks, however, may not have considered all of the implications of making the switch”

RADAR SCREEN BLIP

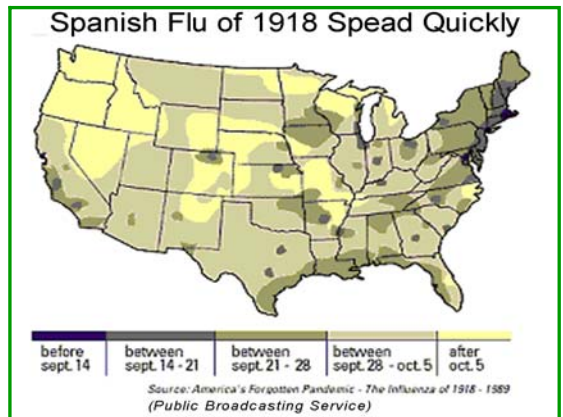
Avian Flu—A Good Time to Prepare



On March 15, 2006, an interagency advisory, "Influenza Pandemic Preparedness," was issued (see SR letter #06-5) to raise banker awareness of the threat from a pandemic influenza outbreak (avian flu). H5N1, the strain of avian flu circulating predominantly in Asia, attacks the respiratory and gastrointestinal tracks of birds and transfers between the bird populations through contact with an infected bird. To date, H5N1 has demonstrated a mortality rate as high as 70 percent in humans; however, infected individuals have been primarily limited to the avian livestock industry. The unique property of an influenza virus is how easily it mutates; thus, it can quickly become resistant to drugs. A pandemic could occur if it mutates into a strain easily passed among humans. However, it is difficult to know if or when H5N1 will mutate because the evolution of an influenza virus cannot be predicted.

The Spanish Flu in 1918-1919 was the most lethal influenza pandemic of the 20th century. It infected approximately 20 percent of the world's population and killed anywhere from 20 to 50 million people. Approximately 25 percent of the U.S. population was infected, with an estimated 675,000 deaths. The mortality rate was 25 times greater than a normal seasonal flu. Although influenza is usually of greatest risk to children and the elderly, in this instance young adults were among the hardest hit groups. As shown on the accompanying map, the Spanish Flu spread rapidly through both urban and rural areas and in approximately three weeks the infection had spread across the country. Though health services have improved significantly since 1918, advancements in international and intercontinental transportation could spread the illness faster and farther.

Pandemic Preparedness: Bankers could perform a risk assessment to understand the impact from an influenza pandemic and consider the effect it would have on the availability of bank services, including the banks' service providers. Based on the risk assessment, the board can decide whether to amend their current business continuity plan to include a response for an influenza pandemic. The expected duration of the pandemic could be weeks or months, with intensity worsening over time, which is different from responding to a one-time event where subsequent conditions are relatively static. Bankers might consider long-term scenarios, including the potential for high employee mortality rates. The following are additional points bankers might consider:



- » Identify essential employee roles and service providers and minimum staffing requirements to maintain key services.
- » Educate employees about the virus, its symptoms, methods to prevent infection (hygiene), and how to care for ill family members; have sufficient infection control supplies available.
- » Consider how customers' demand for goods and services, e.g. cash and extensions on credit instruments, may change during a pandemic.
- » Establish special guidelines for sick leave, flexible working conditions, and telecommuting to minimize employee exposure.
- » Ensure communications and IT infrastructures can support increased use of remote access and e-banking.
- » Consider impact from travel restrictions, e.g. border closures and quarantines, and establish guidance for restricting travel and evacuating employees in infected areas.
- » Review BCP plans of critical service providers to assess their availability.
- » Identify government and community resources for pandemic information and support available from health care providers.

Sources: Centers for Disease Control, Stanford University, U.S. Department of Health, and the Public Broadcasting Service.

The primary purpose of this report is to communicate banking risk issues to internal staff of the FRBSF Division of Banking Supervision and Regulation, and to provide a publication that FRBSF staff can share with supervised banking institutions and others to further the two-way exchange of information. It is made available to the public at <http://www.frbsf.org/publications/banking>

Opinions expressed herein do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco or of the Board of Governors of the Federal Reserve System.

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