

Compliance Topics

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Focus: Managing Compliance Risk

About this Publication

We try to keep in touch with the issues and concerns of western bankers through a variety of mechanisms. One particularly successful approach has been the creation of a Federal Reserve Community Perspectives (FRCP) program (formed in 2002). The FRCP program's objective is to foster two-way information exchanges which gather information and perceptions from bankers on the economy, local business issues, and the effectiveness of Fed supervision, services, and other initiatives.

(Continued on page 2)

COMPLIANCE TOPIC

Flood Insurance Protects Lenders



The vivid images of New Orleans after Hurricane Katrina brought the dangers of flooding to the attention of the nation. But flooding isn't just associated with hurricanes. Flooding is a fairly common occurrence that presents a real financial risk to homeowners and lenders alike. According to the National Flood Insurance Program (NFIP) website, flooding typically causes more than \$2 billion in damage every year in the U.S. and total property losses are likely to exceed that figure substantially in 2005. Obtaining flood insurance is one way of mitigating the risk of financial loss associated with this all too frequent event.¹

Mandatory flood insurance was first required by the Flood Disaster Protection Act of 1973 (FDPA). The FDPA prohibited lenders from making, increasing, extending, or renewing any loan secured by improved real estate located in a special hazard flood area (SFHA) unless the building was covered for the life of the loan by flood insurance. SFHAs are areas within a flood plain that have a 1 percent or greater probability of sustaining flood damage in any given year. Although a 1 percent probability may sound low, it translates into a 26 percent chance of sustaining flood damage over the life of a typical 30-year mortgage. By comparison, there is only a 9 percent chance of sustaining fire damage in the same period.²

In 1994, the provisions of the FDPA were strengthened by the National Flood Insurance Reform Act, which imposed important new obligations on lenders. The current law requires lenders to:

- » Determine whether the collateral property for a loan is, or will be located in an SFHA;
- » Document the determination using the Standard Flood Hazard Determination Form;
- » Require flood insurance in the appropriate amount, when necessary; and
- » Ensure that flood insurance is maintained for the life of the loan.

(Continued from page 1)

After hundreds of one-on-one meetings with bank presidents and CEOs over the past three years, we have a pretty good idea of their top concerns. It should come as no surprise that a frequent theme has been the high cost of regulatory compliance. Over the past year, the most commonly voiced areas of concern have pertained to the Sarbanes-Oxley Act and the Bank Secrecy/USA Patriot Acts, both of which are discussed in this report.

This edition of "On the Radar Screen" does not provide guaranteed solutions to compliance problems or make compliance costs go away (sorry!). Instead, we provide some background and guidance on a few of the more challenging areas of compliance. In addition, we discuss some of the top risks faced by Twelfth Federal Reserve District banking organizations.

We hope this publication is useful to readers in providing some insight into the current concerns of banking supervisors.

While the requirements of the laws are not new, recent examinations have identified an increase in violations of the flood insurance provisions. Such violations were the second most-common type of compliance violation noted at Federal Reserve examinations nationwide in 2004, and the frequency of violations is likely to increase further in 2005. Non-compliance not only exposes banks to the risk of loss if the property is damaged in a flood, it also exposes the bank to the possible imposition of civil money penalties (CMPs) of \$385 per violation up to \$125,000 per calendar year for a "pattern or practice" of violations.

So, what can bankers do to ensure that they protect the value of their real estate collateral against flood damage and remain in compliance with the law? We suggest a few simple actions:

- » Review existing portfolios to ensure that all loans are covered by adequate flood insurance;
- » Review lending policies and procedures for both consumer and commercial lending to ensure that they require flood hazard determinations and adequate insurance coverage;
- » Educate lending staff of the requirements of the law. Remind them that no matter how good the customer, insurance is mandatory and must be in place at loan closing;
- » Ensure that loan files contain adequate documentation of compliance with the law; and;
- » Ensure that an adequate monitoring program is in place to identify and correct coverage lapses. Don't forget that if the borrower fails to renew their policy, the law requires the lender to force coverage.

¹ National Flood Insurance Program Website: <http://www.floodsmart.gov>

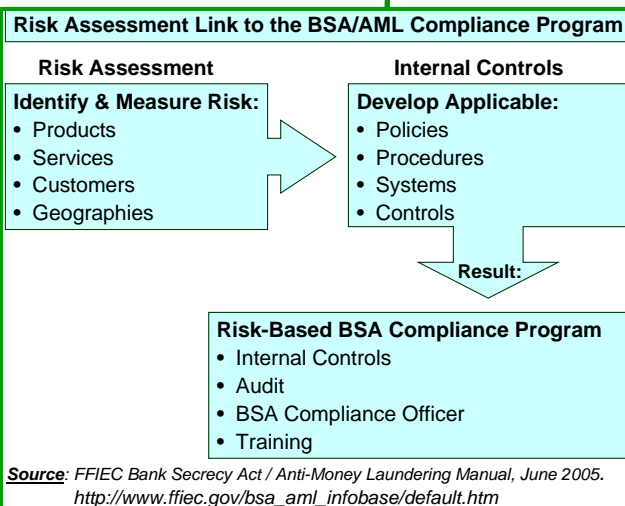
² Flood Damage Statistics: <http://www.floodsmart.gov/floodsmart/pages/statistics.jsp>

COMPLIANCE TOPIC

BSA/AML Compliance: Assessing Risks and Avoiding Pitfalls



Earlier this year, the federal banking agencies announced the release of the FFIEC Bank Secrecy Act (BSA) / Anti-Money Laundering (AML) Examination Manual. The manual is the result of collaboration among the regulatory agencies, who sought to promote further consistency in the examination process while providing a comprehensive resource on BSA/AML topics to examiners and the public. The established examination procedures are designed to be tailored to the risk profile of each institution. Therefore, a key focus is the importance of sound risk management in establishing an effective BSA/AML compliance program.



Financial institutions need to take reasonable steps to combat money laundering and terrorist financing and to minimize their vulnerability to risks associated with such activities. The BSA/AML risk assessment is a key tool which enables firm management to identify potential money laundering and terrorist financing risks across the entire organization and to allocate the appropriate resources for controlling those risks. In developing the risk assessment, management should consider a number of factors, including the risks associated with each of the organization's products and services, customer base, and geographic locations. A risk assessment can serve as a valuable tool to ensure that policies, procedures, systems, and controls are designed to address the BSA/AML risks related to a bank's specific products. Since the risk profile of an institution

may change as the organization offers new products and services, expands, or changes its customer base, the risk assessment process should be seen as dynamic, with the BSA/AML compliance program evolving in response to these changes. Ultimately, an effective risk-based BSA/AML compliance program will enable management to allocate resources, including staffing, training, systems, and independent testing, more effectively by focusing attention to the higher risk areas.

Some of the most-common pitfalls that institutions have encountered in establishing effective BSA/AML programs include:

- » Monitoring processes are not commensurate with the institution's risk profile, size, and/or complexity, or do not adequately address higher risk areas.
- » Management has not assessed BSA/AML risks adequately or provided the appropriate resources, structure, and/or internal controls to mitigate those risks.
- » The scope of independent review does not include sufficient transaction testing to ensure that BSA compliance systems and processes are truly effective.

The BSA/AML risk assessment is a key tool which enables management to identify potential money laundering and terrorist financing risks across the entire organization and to allocate the appropriate resources for controlling those risks.

COMPLIANCE TOPIC

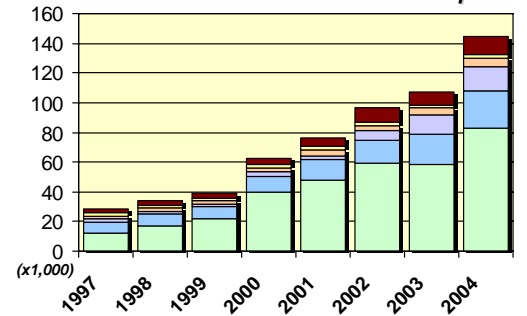
SARs Increase As Monitoring Improves



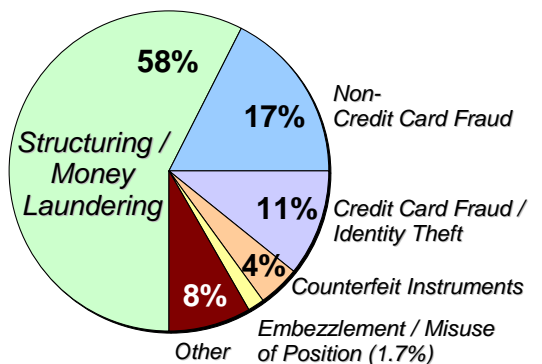
Filings of Suspicious Activity Reports (SARs) by financial institutions in the 12th District have been increasing steadily since they first began being tracked, rising from 27,210 in 1997 to 129,260 in 2004.³ Some attribute this increase in filing activity to an improvement in banking organizations' ability to identify suspicious transactions, for example through the implementation of automated monitoring systems. Throughout this period, the proportion of SARs reporting possible structuring / money laundering activities has consistently represented about 60 percent of total filings, while suspected non-credit card fraud (i.e.. check, wire transfer, loan fraud) has represented approximately 18 percent of filings. The number of filings reporting suspected terrorist financing activity has remained relatively small at under 1/10th of one percent of total filings. The fastest-growing category of SARs has been in alleged fraudulent activities such as credit card-related fraud and identity theft. Reports of credit card fraud more than doubled between 2001 and 2004, currently representing over 8 percent of total 12th District SARs, while identity theft reports have increased sharply from 1,388 in 2003 to 5,438 in 2004.⁴ The only area for which the number of SARs filed has remained relatively constant has been on insider-related activities such as embezzlement and misuse of position. Filings of these types of activities remain relatively static at around 2,000 SARs annually.

The quality of SAR data is paramount. In order to ensure that law enforcement has access to the best data possible regarding financial crimes, it is critical for institutions to implement a consistent, complete methodology for identifying, researching and reporting all suspicious activities. With regard to SAR decision-making, banking organizations should have clear procedures in place to guide appropriate personnel in making SAR filing decisions. Bankers should refrain from reporting an incident if they have investigated the suspected activity and determined that the incident was not suspicious (although they should be sure to document the investigation!). The decision to file a SAR remains an inherently subjective judgment, and the role of the bank examiner is to assess whether banking organizations have followed their SAR decision-making processes in order to reach their SAR decisions.

SARs Filed on 12th District Suspects



12th District SARs Filed in 2004



³ <http://www.fincen.gov/sarreviewmay2005.pdf>
⁴ Identity theft was first tracked (for full year) in 2003.

RADAR SCREEN BLIP

Housing Bust: Biggest Risk To CRE Markets?



Overall Favorable Market Outlook — Housing Bust Scenario: Loss of Jobs, CRE Risk

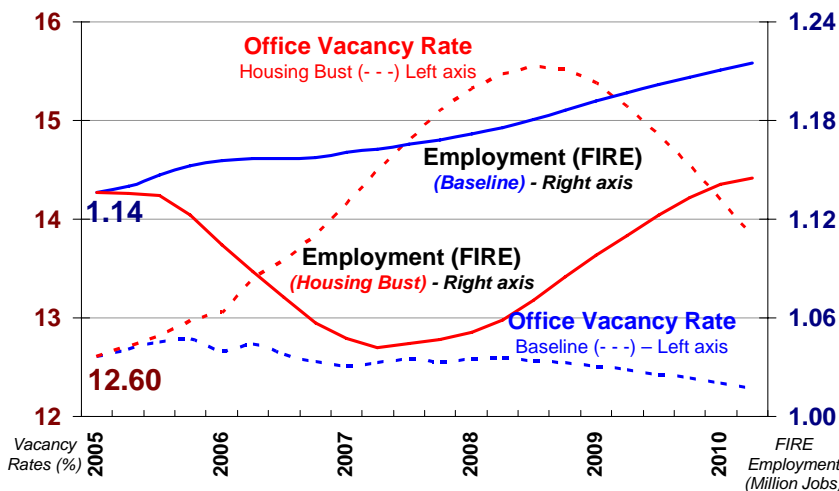
Commercial real estate (CRE) lending concentrations remain on our radar screen. However, market conditions are on the mend, with vacancy rates continuing to edge downwards. For example, over the past two years, office vacancy rates declined in 51 of the 56 major metropolitan areas in the country by an average of 280 basis points. Some of the strongest vacancy rate declines (two years through 9/2005) have been in the West: Orange County (-770 basis points to 7.2%); San Francisco (-590 bp to 14.4%) and Phoenix (-530 bp to 13.7%). Most expect CRE markets to continue to strengthen slowly over the next several years.

One risk to the favorable outlook is the possibility of a residential housing bust. Although most economists do not anticipate this occurring on a broad geographic scale, we can't ignore the small possibility. A significant decline in prices would be painful to homebuyers who both purchase near the peak of the market, and suffer some other economic hardship such as a job loss. With home prices falling, there would be less opportunity for these new homeowners to refinance/consolidate debt. For these reasons, lenders would see some deterioration in credit quality. However, mortgage lending generally has not produced high delinquency or loss rates in the past, because people do everything they can to avoid giving up their homes.

A greater risk to lenders in a housing bust scenario may be the impact on other credit areas that historically have produced more volatile returns. Construction and commercial real estate lending are such areas. Geographic areas that suffer from a sharp house price correction (e.g. down 10-20% over several years) would likely suffer significant job losses as real-estate related businesses slow down. Such job losses could occur in construction, mortgage finance, real estate sales, etc.

One recent stress analysis⁵ by Torto Wheaton Research assumed a sharp housing downturn across the country resulting in the gradual loss of the past ten years worth of real estate-related job growth, along with related declines in personal income.

Potential Housing Bust Could Impact CRE
Office-Using Employment Jobs Could Decline Resulting in Rising Vacancy Rates



Source: Torto Wheaton Research Winter 2006 Forecast, Aggregate of 12th District Markets;
FIRE = Finance, Insurance, and Real Estate jobs

The forecast impact on 12th Federal Reserve District MSAs for office job growth and office vacancy rates is depicted in the chart at left. If this scenario played out, there would be significantly lower net absorption of CRE space, leading vacancy rates to reverse direction and climb for several years.

A main assumption of this exercise is that the MSAs that benefited the most from the housing boom in terms of job growth would be most vulnerable to losing jobs in the event of a bust. MSAs that have economies significantly dependant on real estate activity include high growth areas such as Las Vegas, Phoenix, and Salt Lake City.

The table below presents current and forecast data for 12th District MSAs in three property sectors: office, industrial, and multi-housing. Even before applying the "housing bust" scenario, the "baseline scenario" calls for some near-term slowing based on expected increases in long-term interest rates and modest slowing of housing market conditions. However, based on the "housing bust" assumptions, forecast vacancy and availability rates climb up appreciably, giving up most of the gains made over the past 2 years. The expected impact would vary across MSAs with the greatest impact on high growth MSAs such as Las Vegas, Phoenix, Portland, Sacramento, Salt Lake City and Seattle. These MSA have pro-forma vacancy or availability rates well above their norm in at least two property sectors. Some of the MSAs, such as Tucson, might be significantly impacted by a housing bust scenario, but their forecast vacancy rates would still remain relatively low.

Although stress analyses such as the one below are unlikely to represent actual future market conditions exactly, they do serve as useful "what-if" scenarios for identifying potentially-vulnerable markets under a severe set of assumptions. Even if none of these markets experience a housing bust of the magnitude suggested, some of them may experience smaller corrections. Portfolio stress testing is a useful planning exercise for a potential economic shock, such as a housing bust, and may lead to valuable preparation in case the unlikely becomes a reality.

Portfolio stress testing is a useful planning exercise for a potential economic shock, such as a housing bust, and may lead to valuable preparation in case the unlikely becomes a reality.

⁵ Torto Wheaton Research Outlook products & "The Economic Outlook Underlying TWR's Winter 2006 Baseline Forecast and Scenarios," Torto Wheaton Research, November 22, 2005.

Disclaimer: The data presented in the article above represent only one potential, privately-produced scenario and should not be construed as an endorsement from the Federal Reserve; No internal Federal Reserve System forecasts were considered.

"Housing Bust" Scenario and Impact on Forecast Vacancy Rates

	Average of Vacancy Rate Forecast Diffs. (%) [*]	Office				Industrial				Multi-Housing			
		Current Vacancy Rate 9/05 (%)	Baseline Forecast Vacancy Rate 12/07 (%)	"Bust" Forecast Vacancy Rate 12/07 (%)	Diff. Between Base & Bust (%)	Current Availability Rate 9/05 (%)	Baseline Forecast Avail. Rate 12/07 (%)	"Bust" Forecast Avail. Rate 12/07 (%)	Diff. Between Base & Bust (%)	Current Vacancy Rate 9/05 (%)	Baseline Forecast Vacancy Rate 12/07 (%)	"Bust" Forecast Vacancy Rate 12/07 (%)	Diff. Between Base & Bust (%)
Nationwide Top 5													
Orlando	5.4	12.1	14.1	20.6	6.5	7.2	8.8	12.0	3.2	2.3	3.0	9.4	6.4
Austin	4.5	18.6	13.9	18.8	4.9	15.9	13.2	19.0	5.8	4.4	2.9	5.8	2.9
Tucson	3.7	10.7	7.4	11.2	3.8	8.8	5.5	11.5	6.0	5.8	4.7	5.9	1.2
Las Vegas	3.7	11.9	12.8	15.5	2.7	6.7	11.2	16.3	5.1	2.9	5.6	8.8	3.2
Salt Lake City	3.6	14.7	15.3	21.1	5.8	8.8	9.3	11.4	2.1	4.9	3.7	6.5	2.8
Other West													
Phoenix	3.3	13.7	13.8	17.3	3.5	9.5	13.4	16.8	3.4	5.3	5.5	8.4	2.9
Seattle	2.1	12.9	11.8	14.2	2.4	7.6	7.9	12.2	4.3	4.4	6.4	6.1	-0.3
Riverside	1.8	9.4	11.4	14.7	3.3	4.7	7.1	9.8	2.7	3.5	4.3	3.8	-0.5
Portland	1.6	14.1	14.4	16.1	1.7	8.7	9.4	11.8	2.4	5.1	6.9	7.6	0.7
Sacramento	1.5	15.1	16.3	18.4	2.1	13.8	15.2	17.2	2.0	4.1	6.8	7.2	0.4
San Diego	1.5	10.8	14.8	18.5	3.7	8.9	10.6	12.1	1.5	2.6	5.8	5.1	-0.7
Ventura	1.5	5.3	10.0	11.4	1.4	6.7	10.0	11.6	1.6	n/a	n/a	n/a	n/a
Orange County	1.3	7.2	7.9	11.0	3.1	6.3	7.7	8.3	0.6	3.0	5.1	5.3	0.2
San Jose	1.3	14.6	14.1	15.0	0.9	14.4	11.9	14.5	2.6	2.8	4.1	4.5	0.4
Oakland	1.2	14.2	11.4	12.5	1.1	10.2	11.1	13.4	2.3	3.3	5.7	6.0	0.3
Los Angeles	0.6	12.2	12.4	13.1	0.7	4.7	6.0	6.8	0.8	2.2	3.6	3.9	0.3
San Francisco	0.3	14.4	11.9	12.3	0.4	7.2	9.6	10.7	1.1	3.8	7.2	6.5	-0.7
Honolulu	0.3	13.9	13.3	13.5	0.2	n/a	n/a	n/a	n/a	5.5	4.3	4.6	0.3
12th District	1.5	12.6	12.5	14.5	2.0	7.7	9.0	11.0	2.0	3.4	5.1	5.6	0.5

* Average of differences between percentage point vacancy rate forecasts for year end 2007. Sorted in descending order.

Source: Torto Wheaton Research Winter 2006 Outlook; red shading = > 3 percentage point impact.



Adverse reports cited weaknesses such as an insufficient number of qualified financial reporting staff and/or ineffective internal controls over accounting.

RADAR SCREEN BLIP

Sarbanes-Oxley Implementation Challenges



Legal & Reputational Risks — SOX 404 Issues

Three years after the enactment of the Sarbanes Oxley Act in 2002 (SOX), all of the provisions have been implemented. Generally speaking, Twelfth District banking companies have acted to ensure they are in compliance with various requirements such as auditor independence and CEO/CFO certification of financial statements.

In 2005, the SOX requirement that received the most attention was Section 404, which stipulates that company management must attest to the effectiveness of internal controls over financial reporting. Additionally, the external auditor must opine on the attestation. According to a Board of Governors survey of publicly traded banking organizations, 37 (about 8 percent) reported a material weakness in their internal controls over financial reporting. Although most Twelfth District supervised institutions that are subject to the Act received an unqualified opinion from their external auditors, a small number received an adverse opinion. These adverse reports cited weaknesses such as an insufficient number of qualified financial reporting staff and/or ineffective internal controls over accounting.

So far, investors have not penalized those public companies reporting a material weakness. According to a study performed by Standard and Poor's, the stock price and other market indicators for these firms did not change significantly after the announcements. However, investors may have been accommodating thus far because they recognized that companies were grappling with a new and challenging requirement for the first time. Those investors are likely to be less tolerant of banking companies that do not take corrective action promptly to remediate the noted weaknesses, especially if those firms receive an adverse opinion for a second consecutive year. Legal and reputational risks would increase significantly for those few institutions that do not meet this challenge.

COMPLIANCE TOPIC

Response Program for Security Breaches



Identity theft and other Internet-based crimes have increased markedly over the past couple of years. Just as importantly, public sensitivity to this growing threat has been heightened as several thefts of non-public information have made headlines this year. To help address these growing operational and reputational risks, federal banking agencies issued an interpretation⁶ of section 501(b) of the Gramm Leach Bliley Act in March that directs banking organizations to “develop and implement a response program designed to address incidents of unauthorized access to customer information maintained by the institution or its service provider.”

The new interpretation, which is now in effect, has two main parts: the Response Program and Customer Notification.

Response Program Elements:

1. Assess the nature and scope of an incident; i.e., identify what systems and customer information were accessed or misused;
2. Notify the primary federal regulator as soon as the institution becomes aware of incident;
3. Notify law enforcement and file Suspicious Activity Reports, when appropriate;
4. Contain and control the incident, e.g., by monitoring, freezing or closing affected accounts, while preserving records and other evidence; and,
5. Notify affected customers (or authorize service provider to notify them).

Customer Notification Guidance:

1. An institution should notify affected customers whenever the institution:
 - becomes aware of an incident of unauthorized access to sensitive customer information, AND,
 - concludes that misuse has occurred or is reasonably possible.
2. If it is unable to determine which customers have specifically been affected, the institution must notify all customers in the affected group;
3. Law enforcement (LE) may delay notification if:
 - LE believes that notification may interfere with a criminal investigation, AND,
 - A written request is provided to the institution, but,
 - Notification must be made as soon as this is no longer the case.
4. Customer notifications must be clear and conspicuous, and should be delivered in any manner designed to ensure that a customer can reasonably be expected to receive it.

⁶ The full release is available at: <http://www.fdic.gov/news/news/financial/2005/fil2705.html>



12th Federal Reserve District

COMPLIANCE TOPIC

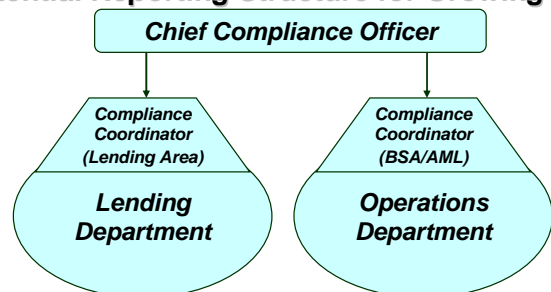
Compliance Growing Pains At Small Banks



Bank examiners have cited “growing pains” as a frequent matter requiring board attention. Risk management processes that are effective at an institution with \$100 million in assets often become ineffective as the institution grows to \$500 million and beyond and increases the array of products it provides. During a period of rapid expansion, an institution generally hires more staff in lending and operational areas, which directly support increasing revenues, but the institution often does not hire additional compliance or audit staff, as these positions may not translate directly to improvements in the bottom line.

Some institutions have dealt with this problem successfully by altering their compliance structure and ensuring that policies and procedures are updated appropriately. For example, instead of hiring an additional compliance officer as an institution grows larger, it may make sense to refine the duties of existing members of the lending and operational areas by assigning specific individuals with responsibility for the internal controls of their current areas. These individuals, who may or may not report directly to the Chief Compliance Officer (CCO), often form a committee that meets regularly to address compliance issues in their respective areas. Overall coordination of the compliance program, along with regular reporting to the Board of Directors and senior management, is handled by the CCO. Such an arrangement has proven valuable to many institutions, since these newly designated compliance coordinators are intimately aware of the operations in the areas they operate and they are often able to encourage peers to ensure that everyone in the organization is responsible for compliance. As long as the accountabilities of these positions are clearly-delineated and a periodic independent review or audit validates the effectiveness of the controls, this arrangement can help to ensure that growing banks maintain a strong compliance program.

Potential Reporting Structure for Growing Bank



Note: This is only one possible reporting structure. Many institutions may be better suited to use an alternate system. Effective risk management is the goal!

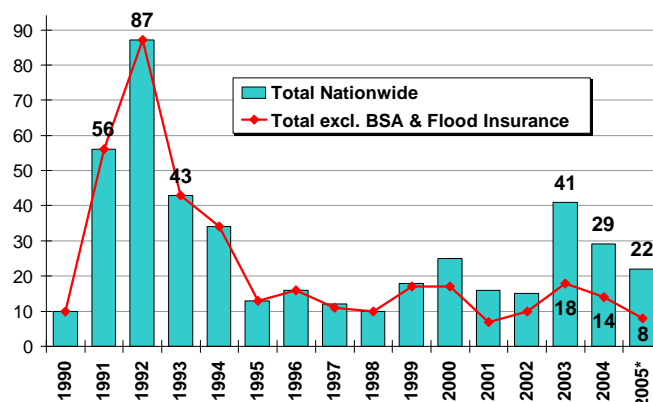
COMPLIANCE TOPIC

Updated Requirements Lead to Increasing Formal Actions

Supervisors use formal enforcement actions when routine supervisory recommendations or informal actions are deemed insufficient or when violations trigger formal action by statute. These formal actions, such as written agreements, cease and desist orders, civil money penalties, and prohibition and removal orders, which are disclosed to the public, are employed infrequently. Since 1995, formal Federal Reserve actions against institutions nationwide have averaged fewer than 20 per year.

Historically, the number of formal actions has paralleled the condition of the banking industry. The recession and real estate downturn of the early 1990s resulted in large numbers of troubled banks and similarly large numbers of formal enforcement actions intended to correct problems. As banking conditions improved, the trend in enforcement actions declined – at least through 2002. As shown in the chart, the number of formal enforcement actions pertaining to institutions has risen significantly since 2002, despite banking conditions remaining generally strong over this period.

Changes in the banking environment and new banking legislation have contributed to this trend. For example, the National Flood Insurance Reform Act of 1994 included a requirement that regulators impose civil money penalties in certain situations. Necessary clarifying guidance came out several years later and flood insurance violations have accounted for 31 percent of the formal actions against institutions since 2003 (most flood insurance actions have been relatively small civil money penalties). Actions related to the Bank Secrecy Act (BSA) have also contributed to the recent numbers, accounting for 26 percent of total formal actions since 2003. These trends point to the growing importance of regulatory compliance, both to bank supervisors who must evaluate compliance in a wide range of areas, and to bankers who must implement internal controls and provide staff training for these areas. It is hoped that as institutions continue to improve these important compliance programs, the numbers of BSA, flood insurance, and other compliance actions will decline.

Federal Reserve Formal Enforcement Actions

Source: Federal Reserve – *2005 totals are through October; includes actions pertaining to financial institutions only (excludes actions pertaining to individuals); the totals are higher than the number of unique enforcement cases since some cases result in multiple formal actions (e.g. written agreement combined with civil money penalties)

RADAR SCREEN BLIPS

We seem to have covered more “tips” than “blips” in this edition of ‘*On the Radar Screen.*’ With the limited room left, we’ll at least list our major radar screen blips – areas we’re monitoring closely for developing trends:

- ◆ **Credit Risk** - *Construction / CRE Loan Concentrations, Consumer Lending (primarily mortgage lending)*
- ◆ **Market & Liquidity Risk** - *Interest Rate Risk, Liquidity (non-core funding reliance), Mortgage Banking / Asset Securitization*
- ◆ **Operational Risk** - *Audit / Internal Controls / Fraud Detection, Network & Information Security*
- ◆ **Legal & Reputational Risk** - *BSA/AML Compliance, Consumer Compliance Management, Sarbanes-Oxley Implementation*

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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