

Issues

Pension Reform in Mexico

U.S. financial institutions and insurance companies will participate in the privatization process, largely by developing partnerships with Mexican banks and insurance companies.

Until all rules and regulations regarding Mexico's pension reform are published, the information in this report is subject to change; however, any changes are expected to be minor and should not affect the author's conclusions. The Comisión Nacional del Sistema de Ahorro para el Retiro (CONSAAR), the regulatory body overseeing pension reform in Mexico, is responsible for developing, implementing and publishing the rules and regulations.

Mexico plans to change from a pay-as-you-go national pension system to a privatized pension system by July 1, 1997, affecting an estimated 10 million private-sector workers. Contributions currently paid by employers, workers and the government to Mexico's social security agency will be redirected to individual accounts managed by the private sector. The government estimates that \$3 billion will flow into these accounts annually.¹ U.S. financial institutions and insurance companies will participate in the privatization process, largely by developing partnerships with Mexican banks and insurance companies, as was done in Chile when it privatized its pension system in 1981. Competition among the approximately 15 private companies applying for a license to manage individual retirement accounts will be fierce. But mutual benefits derived through partnerships between domestic and foreign entities should generate profitable synergies to enhance long-term success.

Why Pension Reform?

Mexico's pension reform is being driven by pension liabilities that are financially unsustainable over the long term and by the government's desire to raise the country's internal rate of savings. These same motivating factors prompted the privatization of Chile's pension system in 1981 (see the sidebar entitled "The Chilean Model" on page 4). Chile's success in increasing savings to one of the highest rates in Latin America has caught the attention of other Latin American governments that hope to realize similar results (Table 1).

Mexico's pension system has been operating under a deficit for several years. To eliminate this deficit and retain the current pension system, the premiums paid by employers, employees and the government

Table 1
Savings Rates in
Latin American Countries

(Savings as a percentage of gross domestic product)

	Average percentage 1988-94	Average percentage 1981-87
Argentina	19*	22
Brazil	22	22
Chile	29	16
Colombia	22	20
Mexico	20	26
Venezuela	23	24

NOTE: *1988-92.

SOURCE: Board of Governors of the Federal Reserve System.

Table 2
Contributions Under Mexico's Old and Proposed Pension System

Division	Participation	Old system			Proposed system		
		To IMSS	To Individual SAR Account	To INFONAVIT	To AFOREs	To IMSS*	To INFONAVIT
Disability, retirement, severance and life insurance	Tripartite**	8.5%	—	—	4.5%	4%	—
SAR	Employer	—	2%	—	2%	—	—
INFONAVIT	Employer	—	—	5%	—	—	5%
Social contribution	Government	—	—	—	2%***	—	—
Subtotal		8.5%	2%	5%	8.5%	4%	5%
Total			15.5%			17.5%	

* Worker contributions to the IMSS will be used to provide life and disability insurance, as well as cover medical expenses of retirees and disabled workers.

** Paid as follows: 70 percent by employer, 25 percent by employee and 5 percent by government.

*** Estimated percentage for the average wage worker.

SOURCE: IMSS and CONSAR.

would have to increase from 8.5 percent of wages to 23.3 percent by 2020.²

Domestic savings in Mexico declined from an average of 26 percent of gross domestic product (GDP) between 1981 and 1987, to 16 percent of GDP at year-end 1994. The government's goal is to increase domestic savings to 22 percent of GDP by the year 2000, for a gain of 6 percentage points above the current level. A domestic savings rate of 22 percent of GDP plus foreign savings equal to 2 percent of GDP are needed to support the government's GDP growth forecast of 5 percent annually, as outlined in Mexico's National Development Plan 1995–2000.

Characteristics of Mexico's Existing National Pension System

Under the existing Mexican pay-as-you-go pension system, employers, employees and the government together contribute 15.5 percent of a worker's salary for retirement and housing benefits (*Table 2*).³ Most of these contributions (8.5 percent) are paid to the Mexican Institute of Social Security (IMSS), the government agency responsible for providing retirement and other benefits to Mexican workers. The balance of the contributions is directed to the Retirement Savings System (2 percent) and to the National Housing Fund (5 percent), known by its Spanish acronym, INFONAVIT (see glossary on page 6 for a complete listing of acronyms used in this report).

The Retirement Savings System (SAR) began in 1992 when employers were required to contribute 2 percent of every worker's salary to an account for the direct benefit of the employee. SAR funds, which have accumulated to approximately \$3 billion, belong solely to employees to supplement government retirement benefits. SAR accounts are managed by Mexican banks, and proceeds are forwarded to Mexico's central bank, which guarantees a minimum real rate of return of 2 percent annually. During 1995, SAR funds realized a real return of 5.6 percent.

Contributions to INFONAVIT are used to provide housing loans to workers; funds are maintained in segregated accounts for the benefit of each employee. If a worker qualifies for a mortgage loan on the basis of accumulated funds in his or her account, the worker's contributions to INFONAVIT are used as a down payment on a house, and the collective funds remaining in all workers' accounts are used to fund the mortgage. Funds contributed by a worker to INFONAVIT that are not used for housing purposes can be used to supplement retirement benefits from the IMSS, provided INFONAVIT has the financial capacity to pay such benefits. Historically, INFONAVIT contributions have not experienced real returns, and, in fact, the real return in 1995 was –9 percent. Administrative costs of INFONAVIT are very high, and the recovery rate on outstanding mortgage loans has been less than 50 percent.

Under the current system, workers must be at least 65 years old to retire. Pension benefits are based on the average salary over the past five years, although the government guarantees a pension equal to the minimum wage.⁴ For a worker following the average wage path in 1995, the government's pension would replace 50 percent of preretirement wages, provided the worker contributed to the IMSS for 20 years, or 100 percent if the individual contributed for 45 years.⁵

The Mechanics of Mexico's New Privatized Pension System

Under Mexico's privatized pension system, the employer, employee and government together will contribute 8.5 percent of a worker's wages to an individual retirement account. The 8.5 percent includes a new government social contribution of one peso a day to each worker's account that is equivalent to 5.5 percent of the minimum wage at the time the new system takes

The government's goal is to increase domestic savings to 22 percent of GDP by the year 2000.

effect. Subsequently, the government's social contribution will be indexed to the Mexican consumer price index (CPI). As a percentage of total salary, this fixed amount provides a greater benefit to low-wage workers. For the average-wage worker, the government's social contribution amounts to 2 percent of the worker's salary.⁶ Employees are also allowed to make additional contributions to their accounts.

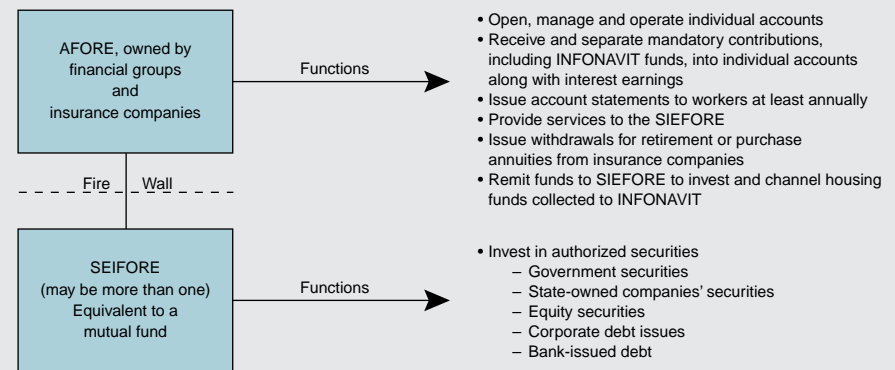
Contributions will be collected by newly formed private companies to be known as AFOREs (Retirement Fund Administrators) whose purpose will be to open, manage and operate individual retirement accounts and remit workers' contributions to a separately capitalized mutual fund to be known by the Spanish acronym, SIEFORE (*Chart 1*).

An AFORE must have minimum capital of \$3 million to obtain a license to operate. Once an AFORE commences operations, it must have an additional \$3 million in capital as a reserve against imprudent losses. As the SIEFORE managed by the AFOREs grows, the capital reserve at the AFORE must be maintained to cover 1 percent of the assets invested by the SIEFORE.

Initially, it is envisioned that an AFORE will be limited to operating only one SIEFORE (mutual fund), which must invest in fixed income securities and inflation-protected instruments. As markets develop and as the retirement needs of workers becomes clearer, other SIEFOREs may emerge. Ultimately, investments permitted by the SIEFOREs will be expanded to include nonfixed income instruments such as stocks and financial derivatives. Maximum limits for each type of instrument will be established, and funds cannot be invested abroad. A SIEFORE's only capital requirement will be initial capital of \$500,000.

AFOREs will generally be owned by financial groups and insurance companies, and foreign ownership is permitted for countries that have signed international accords with Mexico: the United States, Canada and Chile. The pension reform law states that no individual or corporation may own more than 10 percent of the capital of an AFORE, although the pension regulatory authorities are authorized to approve higher percentages. Two exceptions to the 10-percent limit exist: (1) ownership by foreign entities is not subject to the 10-percent limitation, and (2) the IMSS can establish an AFORE.⁷ Hence, privately owned AFOREs will not only compete against each other but will also compete against a government-owned AFORE. Authorities will have to guard

Chart 1
The Functions of an AFORE



against unfair competition by the IMSS-owned AFORE since it may have access to privileged information in the centralized database from all AFOREs.

The pension reform law limits each AFORE's market share, although CONSAR is authorized to approve higher market share percentages. For the first four years, no AFORE may control more than 17 percent of the market. During the fifth year, the limit on market share increases to 20 percent. Market share is measured by the number of accounts, not the total value of the private pension funds managed. One negative aspect of the market share limits is that workers may be prevented from moving funds into their chosen AFORE even though an AFORE might have lower commissions, superior service or higher returns.

Revenues will come from commissions and other miscellaneous fees. Commissions may be based on the value of the assets managed or on the amount of contributions received, or some combination thereof. Fees can also be assessed for additional account statements, inquiries and so forth. Commissions and fees are deducted from the worker's AFORE account.

Transitioning to Mexico's Privatized Pension System

The change from Mexico's current pension plan to a privatized system will affect 10 million private sector workers: current workers, newly re-employed individuals and those entering the workforce for the first time. These workers represent 29.6 percent of the economically active population in Mexico but almost 80 percent of the labor force in the formal sector.⁸ The new pension system will not affect current retirees, whose pension will remain fully funded by

Foreign ownership is permitted for countries that have signed international accords with Mexico: the United States, Canada and Chile.

the IMSS, or public-sector employees, who are covered under a separate government pension plan.

Current workers have the option at retirement of taking program withdrawals from their AFORE accounts to meet pension needs, or remitting accumulated funds in their AFORE accounts to the IMSS in exchange for the pension they would have received under the old system.

For newly re-employed individuals and those entering the workforce for the first time, two options are available at retirement: (1) accept withdrawals from their AFORE accounts or (2) remit funds accumulated in their AFORE accounts to the IMSS in exchange for a government pension equal to the minimum wage in July 1997, adjusted

to the Mexican CPI. To qualify for the government's minimum pension guarantee, workers must contribute to their AFORE accounts for at least 25 years.

The Need to Develop Long-Term Financial Markets

AFORE fund managers, like pension fund managers generally, seek to hold long-term investments that can be funded with their long-term liabilities. Market participants hope that the long-term funds flowing into the AFORES will serve to further develop domestic financial markets and foster broader and deeper markets for long-term financial instruments. For the first year under the new plan, CONSAR projects that worker contributions to Mexican private pension accounts will be \$3 billion, or 0.8 percent of estimated 1997 GDP. By 2007, it is estimated that funds managed by the AFORES will amount to 9.2 percent of GDP, assuming an average annualized real return on investments of 3 percent and average annualized real GDP growth of 3.5 percent over this 10-year period and not including pre-1997 SAR funds (*Chart 2*).⁹

To revisit Chile's success story, long-term capital markets in that country also were undeveloped when the Chilean government initiated pension reform. Today however, the International Monetary Fund notes that Chile is perhaps the only Latin American country with a developed corporate bond market, and its development and growth is related to the long-term funds provided by the privatization of Chile's pension system. Pension funds and insurance companies in Chile hold two-thirds of the corporate bonds outstanding, although the concentration of participants acting as market-makers keeps the Chilean bond market relatively shallow.¹⁰ Of course, the importance of the stable macroeconomic environment in Chile, which reduced investment risk, cannot be ignored as a key factor in promoting the development of the corporate bond market. Likewise, Mexico is aware of the need to maintain stable fiscal and monetary policies as part of the overall reform process.

Can Mexico Achieve Its Pension Reform Goals?

As noted earlier, Mexico has two goals with pension reform. The first is to reduce the government's pension liabilities, which can no longer be financed. The government's guarantee to current workers of a pension equal to no less than would exist under the

The Chilean Model

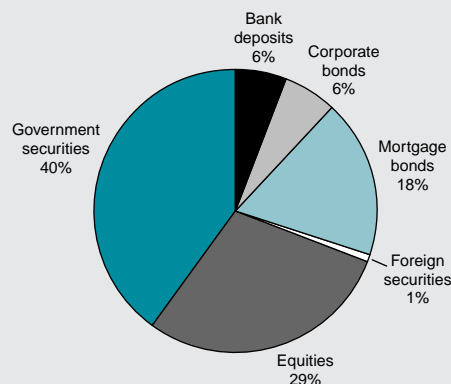
Mexico's proposed privatized pension system follows similar reforms initiated in Chile in 1981 and Argentina in 1994. Proponents of privatization often point to the Chilean model as the success story in raising the national savings rate and contributing to the development of domestic financial markets. However, many studies have concluded that the Chilean pension reform played a small role in the country's dramatic increase in savings. Other reforms—such as changes in the Chilean tax laws to encourage corporate savings and investment, coupled with more stable and effective monetary and fiscal policies—helped promote higher savings and stronger economic growth in Chile.

The mechanics of Chile's pension reform are similar to the reforms Mexico is undertaking. In Chile, workers contribute 10 percent of their salary to retirement savings accounts administered by private entities known by the Spanish acronym, AFP. Unlike the Mexican plan, mandatory contributions to the AFPs are paid solely by Chilean workers. Under the Mexican plan, the employer, employee and government will share in funding the contributions. Commissions to the AFPs are paid separately from worker contributions, whereas commissions under Mexico's plan will be deducted from contributions.

A government agency regulates the AFPs, and AFP ownership by foreign organizations is unrestricted. Assets of the AFPs must be kept separate from the mutual funds they manage, and each fund must attain a minimum rate of return based on a formula that sets maximum deviations from the average return of all managed pension funds operated by AFPs. No such minimum return is contemplated in Mexico's pension reform rules.

As of June 1996, AFPs managed assets of \$28 billion, and 53 percent of these assets were managed by Chile's three largest funds: AFP Provida, AFP Habitat and AFP Cuprum. Funds accumulated by the AFPs are now equivalent to 42 percent of Chile's annual gross domestic product.

Investment Distribution of Chilean Pension Funds, June 1996



SOURCE: Bloomberg.

old system and the guarantee to new workers of a minimum pension casts doubt that substantial savings can be achieved in the short run. CONSAR projects that new workers earning the average wage or less in Mexico will always accept the government's guaranteed pension. Based on 1994 demographics, workers contributing to the IMSS who earned at or less than the average wage in Mexico represented approximately 70 percent of the workers then contributing to the IMSS.¹¹ Although the government will ultimately realize some savings with respect to the 30 percent of workers who will not require a government-funded pension, it may take decades before these savings are realized.

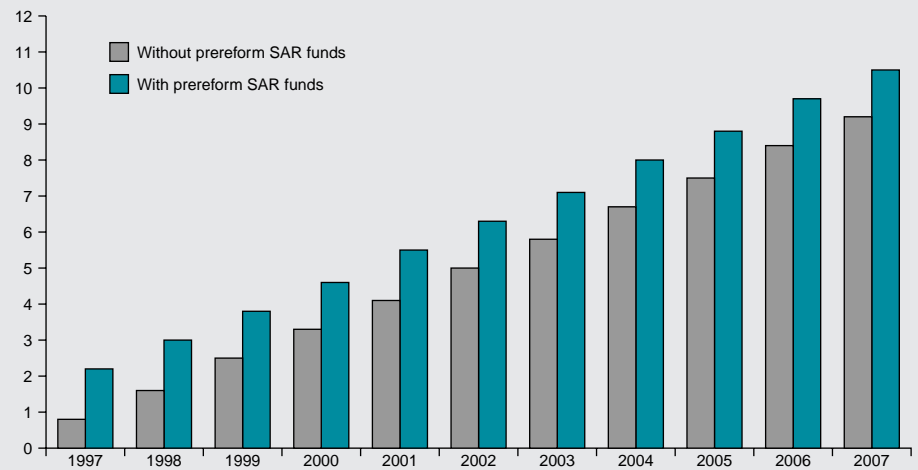
The government's pension guarantee also presents a potential moral hazard problem. Because most of the workers' AFORE accounts are expected to lack funds to exceed the government's minimum pension guarantee, workers may opt for riskier investments in their SIEFORES because they know the government safety net exists. If they do so, and if the riskier investments perform poorly, the expense of providing the minimum government pension guarantee will be higher than expected because the value of the AFORE accounts remitted to the government will have less value.

The second goal of Mexican pension reform is to increase the savings rate in Mexico. Domestic savings can only come from an increase in private savings (individual or corporate savings), an increase in public savings or both. However, contributions flowing into the AFORES are simply being redirected from contributions paid to the government under the old system to the AFORES and do not represent a reduction in consumption or an increase in income for workers. Therefore, pension reform in Mexico, by itself, is not likely to boost the internal savings rate. However, if the AFORES are managed efficiently and higher than expected returns are achieved, some increase in the savings rate may occur.

Pension reform, as designed, also does not appear to encourage public savings, at least in the short- and medium-term. Contributions paid to the government under the old system will be redirected to private pension accounts, representing a loss in government funding. The government will continue to finance pensions of current and future retirees as a result of the minimum pension guarantee, but with the loss in previous funding, the government must pay

Chart 2
Projected Worker Contributions to AFORES: 1997–2007

(As a percentage of gross domestic product)



NOTE: Assumes a real rate of return of 3 percent on workers' contributions and a real GDP growth rate of 3.5 percent.

SOURCE: CONSAR.

its pension liabilities through alternative fiscal means.

Foreign Financial Institutions' Participation in Mexico's Pension Reform

Even with the challenges posed by pension reform, foreign financial institutions have shown great interest in forming partnerships with Mexican financial institutions in the ownership of AFORES (*Table 3*). The main barrier to entry will depend on whether Mexican financial institutions decide to capitalize an AFORE on its own or with a partner. Many observers predict that, to be profitable, foreign entities will need

Table 3
Major Partnerships Announced to Own AFORES*

Mexican company	Foreign partners		
	Insurance company	Bank	Chilean AFP
Grupo Financiero Bancomer—51% (Banking Financial Group)	Aetna Life Insurance Company—33%		Santa Maria—16% (61% owned by Aetna)
Grupo Financiero Serfin—51% (Banking Financial Group)		Citibank (U.S.)—40%	Habitat—9% (34% owned by Citibank)
Grupo Nacional Provincial—51% (Insurance Company)		Banco Bilbao** Vizcaya—25% (Spain)	Provida—24% (41% owned by National Bank of Canada and Chilean businessmen)

* Subject to approval by regulatory authorities.

** Activity will be conducted pursuant to its subsidiary bank in Mexico.

Glossary of Acronyms

AFORE	Retirement Fund Administrator, a private-sector entity that will manage workers' retirement funds under Mexico's new privatized pension system.
AFP	A private-sector entity in Chile that manages Chilean workers' retirement funds.
CONSAR	The regulatory body overseeing Mexico's pension reform process.
IMSS	The Mexican government agency responsible for providing government pensions to workers.
INFONAVIT	The Mexican government agency that provides housing loans to workers.
SAR	Retirement Savings System, which comprises individual retirement accounts set up for Mexican workers in 1992 to supplement IMSS retirement benefits.
SIEFORE	A mutual fund owned by an AFORE that will invest Mexican workers' contributions for retirement.

the distribution networks of Mexican banks to capture sufficient market share. Initially, as many as 15 AFORES may be approved, although future consolidation is expected. The combined strengths of domestic and foreign partners may determine which AFORES are ultimately successful. In Chile, most prominent AFORES have sizable minority foreign investors: either foreign financial institutions or foreign insurance companies.

The privatization of Mexico's pension system provides foreign entities the opportunity to develop a new market niche in Mexico. Foreign participants bring to the pension reform process expertise in risk management and in managing funds invested for long periods. Thus far, Mexico's fund managers have focused primarily on short-term markets. Partnerships developed with foreign participants that have worked with similar pension reforms in other Latin American countries have the potential to generate profitable synergies.

Another reason for interest in domestic and foreign partnerships is that Mexican financial institutions are seeking to raise additional capital. For example, Grupo Financiero Bancomer, the second largest bank in Mexico, and Aetna Inc., a U.S. insurance company, along with Aetna's majority-owned Chilean subsidiary Santa Maria, S.A., have already announced a joint venture to own an AFORE. Aetna Inc./Santa Maria, S.A. will pay \$47 million to Bancomer for its partial ownership, allowing Grupo Financiero Bancomer to complete its goal of raising \$1.1 billion in capital. Thus, the selling of rights to foreign entities to acquire the distribution networks and corporate relationships already developed by Mexican financial institutions can provide capital to the banking industry.

Conclusion

Under Mexico's new privatized pension system, private-sector companies will manage workers' retirement savings, estimated at \$3 billion annually. Foreign financial institutions and insurance companies will participate in the management of the private pension funds largely through partnerships with Mexican entities. Foreign participants will gain the distribution and corporate networks already established by Mexican banks, while Mexican financial institutions will gain foreign participants' expertise in managing long-term funds. These mutual benefits should enhance success as the numerous newly formed private pension management

companies compete against each other.

Mexico's pension reform goals to reduce the government's future pension liabilities and increase the country's savings rate may not be realized immediately. However, the reform sets forth a vehicle through which workers can increase their rate of savings, particularly if Mexico strengthens incentives for savings beyond current levels or if workers realize the benefits of savings through positive real returns.

—Howard C. "Skip" Edmonds

Notes

- ¹ Here and throughout this report, sums are stated in U.S. dollars unless otherwise noted.
- ² Sales-Sarrapy et al. (1996).
- ³ Employers, employees and the government provide an additional 17.5 percent of a worker's salary to cover health and maternity insurance, workplace risk and child care centers.
- ⁴ The current minimum wage in Mexico is 26.5 pesos per day and is based on a 365-day year.
- ⁵ Sales-Sarrapy et al. (1996).
- ⁶ The average wage for workers contributing to the IMSS is three times the minimum daily wage.
- ⁷ The IMSS will retain its responsibility for providing pensions under the old system to current retirees and transition workers. The IMSS will also provide a minimum pension guarantee to new workers should funds accumulated in a worker's account not be sufficient to provide a retirement at least equal to the government's minimum pension guarantee. The IMSS' ability to operate an AFORE is separate and distinct from its responsibilities to provide social pensions.
- ⁸ Sales-Sarrapy et al. (1996).
- ⁹ An AFORE, upon selection by a worker, is authorized to obtain prereform SAR funds held by the Bank of Mexico in the name of the employee. However, the prereform SAR funds will likely be issued as special government bonds to the AFORES to defer the immediate fiscal impact, although a formal decision has not yet been made.
- ¹⁰ Rojas-Suárez and Weisbrod (1995).
- ¹¹ At the end of 1994, the daily minimum wage in Mexico was 15.3 pesos and the average wage of workers affiliated with the IMSS was 3.9 times the daily minimum wage, or 59.3 pesos.

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11K Bank Notes

Agricultural Banks Holding Steady

Earnings for agricultural banks in the Eleventh Federal Reserve District remained strong through the second quarter.¹ The banks' return on average assets was 1.21 percent, matching the District-wide figure for all insured commercial banks and slightly higher than the March 31 agricultural banks figure of 1.20 percent.

Agricultural banks' loan quality remained steady in the second quarter. The ratio of noncurrent loans² to gross loans dipped from 2.30 percent on March 31 to 2.20 percent on June 30. A slight improvement in asset quality also occurred in the agricultural loan portfolio, as reflected by the decrease in the ratio of noncurrent agricultural loans to total agricultural loans from 3.46 percent to 3.35 percent. However, the June 30 value does represent an increase from the year-earlier ratio of 1.87 percent.

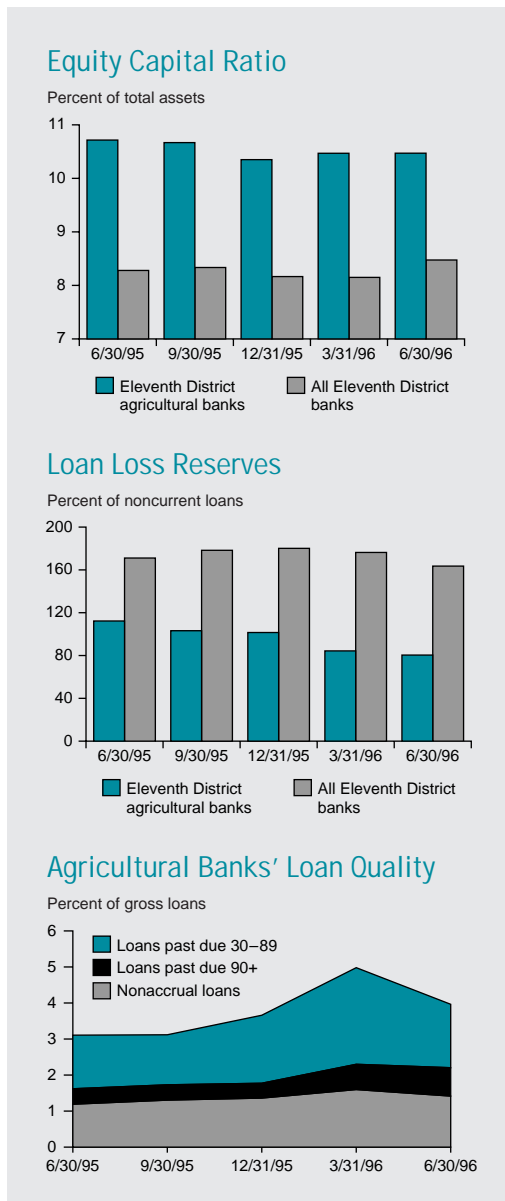
The ratio of loan loss reserves to noncurrent loans continued to decline in the second quarter, falling from 84 percent in March to 80 percent in June.

Agricultural banks' ratio of equity capital to total assets remained well above the District-wide ratio. On June 30, this ratio stood at 10.47 percent, a full 2 percentage points higher than the Eleventh District ratio of 8.47 percent.

Notes

¹ Agricultural banks are defined as banks whose total loan portfolio is composed of at least 25 percent agricultural loans. See *Financial Industry Issues*, Second Quarter 1996, for "Agricultural Community Feels the Heat of Long, Dry Texas Summer," which focused on the financial strength of Texas agricultural banks overall and their ability to weather the financial impact of the recent drought.

² Noncurrent loans are loans past due 90 days or more plus loans on nonaccrual status.



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A New Tool to Increase Examiner Efficiency

Federal Reserve bank examiners are beginning to use new software to make examinations more efficient and less burdensome for financial institutions. Called Examiner Workstation, this new tool allows examiners to utilize electronic data from the financial institutions' databases, eliminating the need for time-consuming manual transcription.

In Release 1.1, Examiner Workstation contains functionality for the electronic accumulation of loan data. The application will eventually encompass all facets of the bank examination, including the analysis of the securities portfolio, the electronic completion of work papers, report-generation activities and financial analysis based on the bank's Call Report.

With the electronic accumulation of data, examiners can analyze this data off-site and use it to help focus on-site work on larger issues, such as risk management. "Bankers encouraged us to use technology more effectively during the exam process," says Dallas Fed Vice President W. Arthur Tribble. "Loan analysis is a very manual function and takes a lot of time. We think we have a product that is a win-win for the banker and the examiner: less time spent in the bank with better analysis and insight."

The Federal Reserve's 12 regional banks supervise state member banks and bank holding companies in their respective districts. Examiner Workstation, when in use throughout the Federal Reserve System, will promote standardization of examinations across the United States. Additionally, each state's bank regulatory agency has been provided with a copy of Examiner Workstation for use on examinations. State member banks interested in the use of this tool on their next examination should contact Danny Oursbourn at the Dallas Fed at (214) 922-6235.

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