FEDERAL RESERVE BANK OF NEW YORK

NEW YORK, N.Y. 10045-0001

AREA CODE 212 720-6375

CHESTER B. FELDBERG
EXECUTIVE VICE PRESIDENT

at-10647a

July 8, 1993

TO ALL STATE MEMBER BANKS, BANK HOLDING COMPANIES,
AND DOMESTIC OFFICES OF FOREIGN BANKS IN THE
SECOND FEDERAL RESERVE DISTRICT

SUBJECT: CLARIFICATION ON REAL ESTATE LENDING STANDARDS

The Federal Reserve Board has received several requests to clarify the new Real Estate Lending Standards[1] in two areas. The first clarification relates to the calculation of the loan-to-value (LTV) ratio for all real estate loans and the second relates to the appropriate supervisory LTV for improved land loans and multiple phase real estate loans. These supervisory LTV limits are set forth in the Interagency Guidelines for Real Estate Lending Policies which are an appendix to the regulation.

The loan-to-value (LTV) ratio is defined as the total amount of credit being extended divided by the value of the underlying property. The total amount of any single credit extension must be combined with the amount of all senior liens in the numerator of the LTV ratio. The amount of any readily marketable collateral or other acceptable collateral may be combined with the value of the underlying real property in the denominator of the ratio. Other non-real estate collateral is considered acceptable, provided that:

- The lender has a perfected security interest;
- The collateral has a quantifiable value and is accepted by the lender in accordance with safe and sound lending practices;
- The lender has appropriately discounted the value of the collateral consistent with the lender's usual practices; and
- The collateral is saleable under ordinary circumstances with reasonable promptness at market value.

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[1] Federal Reserve Board 12 CFR Part 208 (Regulation H). Federal Register 57 FR 62890 (December 31, 1992).

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Examples of readily marketable collateral include: bullion, stocks, bonds, debentures, commercial paper, negotiable certificates of deposit, bankers' acceptances, and shares in mutual funds. The lender may not consider the general net worth of the borrower, which might be a determining factor for an unsecured loan, as equivalent to other acceptable collateral for determining the LTV on a secured real estate loan.

If an institution has multiple loans to the same borrower with one on a secured basis and the other on an unsecured basis, examiners will generally treat the loans as separate loans for determining compliance with the supervisory LTV limits. However, if the unsecured loan does not meet prudent underwriting standards, examiners will consider whether the institution has structured the transaction in such a manner, in order to circumvent the supervisory LTV limits. If it appears that the institution is attempting to circumvent the guidelines, examiners will in such cases treat the two loans as one for adherence to the supervisory LTV purposes. In determining whether to treat the two loans as one, examiners will consider the similarities between the two loans with regard to origination dates and the use of borrowed funds.

The second clarification arises from requests for the appropriate supervisory LTV limit for improved land loans and multiple phase real estate loans. The supervisory LTV table does not specifically set forth a loan category for improved land loans (e.g., an improved residential lot in an established development). Improvements include: streets, curbs and gutters, site grading, and access and connection to water, sewer, gas and electricity. The applicable supervisory LTV for such loans is 75 percent which corresponds to the land development loan category. However, if there have been minimal improvements to the land, and the timeframe for construction of the dwelling or building has not been scheduled to commence in the foreseeable future, the loan generally will be considered a raw land loan with a 65 percent supervisory LTV.

The supervisory LTV limit applicable to an extension of credit funding multiple phases of a real estate project, subject to two or more categories of real estate loans, is the supervisory LTV limit applicable to the final phase of the project. For example, where the loan is for the acquisition and development of land and the construction of an office building in continuous phases of development, the appropriate supervisory LTV for the project loan would be 80 percent (i.e., the supervisory LTV for commercial construction loan). However, this does not imply that the lender can finance the total acquisition cost of the land at the time the raw land is acquired by assuming that this financing would be less than 80 percent of the project's final value.

The lender is expected to fund the loan in accordance with prudent disbursement procedures which set appropriate levels for the hard equity contributions of the borrower throughout the disbursement period and term of the loan. As a general guideline,

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the funding of the initial acquisition of the raw land should not exceed the 65 percent supervisory LTV; likewise, the project cost to fund the land development phase of the project should generally not exceed the 75 percent supervisory LTV limit. In this regard, the borrower is expected to have a cash equity stake from the time of the first loan disbursement.

For a multiple phase 1-to-4 family residential loan where the lender is funding both the construction of the house and the permanent mortgage to a borrower who will be the owner-occupant, there is no supervisory LTV limit. However, if the LTV equals or exceeds 90 percent, the bank should require an appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

Questions on this matter may be directed to Barbara A. Klein, Manager, Domestic Banking Department, at (212) 720-8324.

Yours sincerely,

Chester B. Feldberg
Executive Vice President

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CHESTER B. FELDBERG
EXECUTIVE VICE PRESIDENT

July 7, 1993

To the Chief Executive Officer of Each State Member Bank
in the Second Federal Reserve District:

Banks have become increasingly involved in offering mutual funds to their retail customers, prompting a renewed focus on the role of a bank in the sale of mutual funds, including a bank's responsibility for ensuring customers are made aware of the differences between mutual funds and insured deposit instruments. In some cases, the mutual funds offered by a bank are third-party funds that the bank simply makes available for purchase directly from a distributor. In other cases, the mutual funds offered are private-label or proprietary funds, which may be advised by the bank or an affiliate. In these instances, the banking organization receives some sales-related compensation, and when it is employed by the mutual fund as an investment adviser, it also receives compensation for this service.

State member banks selling mutual fund shares, directly or through a subsidiary, must conduct that activity in compliance with principles of prudent and safe banking. State member banks should take sufficient measures to ensure that their customers understand the nature of mutual fund investments. Prudent measures should also be taken by state member banks to ensure that the sale of mutual funds poses minimal risk to the safety and soundness of the bank.

A state member bank that sells shares of a mutual fund advised by the bank's parent holding company or by a nonbank subsidiary of the parent holding company is subject to additional requirements as set forth in the Board's interpretative rule under the Bank Holding Company Act (12 CFR 225.125(h), as amended 8/92). A state member bank must meet the requirements contained in the Board's interpretive rule as well as the requirements in this letter.

The information presented in this letter is intended to be used as general guidance on an interim basis while a general review is conducted, in conjunction with the other regulatory agencies, of the sale of all uninsured investment products on bank premises. It is expected that, as a result of this review, a more extensive policy statement will be released at a later date and will contain more detailed guidance on the sale of

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mutual funds for use by examiners and the banking organizations supervised by the Federal Reserve System.

Location of Mutual Fund Sales

When mutual funds are sold by bank employees, or are sold in a retail banking area, measures should be taken to ensure that purchasers do not have the impression that the mutual funds are federally-insured deposits or that they are obligations of the banking organization. To lessen the potential for confusion between mutual fund investments and insured bank deposits, mutual funds should be sold in a physical location separate from the area where business involving insured bank deposits is conducted. This area should be distinguished from the routine retail deposit-taking area through the use of signs and other means of identifying the sales area for mutual funds. Bank tellers should not offer any investment advice to any customer. Bank employees should direct customers seeking investment advice to the employee of either the bank or a third-party specifically designated and trained as an investment adviser.

Disclosure

Uninsured Nature of Mutual Funds/Investment Risk

It is important that sales programs targeting retail customers not employ practices that could mislead the bank's customers with respect to the uninsured nature of mutual funds and the investment risk associated with mutual funds. When reviewing the adequacy of mutual fund disclosures, examiners consider whether a bank's disclosures appear to inform investors adequately of the risks associated with the products they are purchasing. To help ensure that retail customers are able to understand the uninsured nature of mutual funds, state member banks should not sell shares of any mutual fund, or allow third parties to sell shares of mutual funds on depository institution premises, in a manner that conveys the impression or suggestion that such instruments are either: 1) federally-insured deposits, or 2) are obligations of, or guaranteed by, an insured depository institution.

Disclosure that mutual funds are not federally-insured and are not obligations of the bank should be displayed prominently in all mutual fund advertising, promotional and sales material issued by the bank. Mutual fund sales confirmations and periodic account statements issued by the bank should also disclose that mutual funds are not guaranteed by the bank, the Federal Deposit Insurance Corporation, or any other government agency.

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At the time any account for the purchase of mutual fund shares is established, customers must be informed, in writing, that mutual fund shares are not deposits or any other type of obligation of the depository institution, the FDIC, or any other government agency. Additionally, the disclosure statement should indicate that the investment is subject to risk that may cause the value of the investment to fluctuate, and that when the investment is sold, the value may be higher or lower than the amount originally paid by the customer. A verbal disclosure can be made but must be followed by written disclosure. To promote customer knowledge of mutual funds, state member banks are encouraged to obtain a statement, signed by the customer, indicating that the customer has been informed and understands that his or her investment is not insured or guaranteed, and that the investment is subject to fluctuation in value.

Bank as Adviser to a Mutual Fund

In instances where a state member bank is selling shares of a mutual fund advised by the bank or an affiliate, the bank should take precautions to ensure that the customer understands the nature of the advisory relationship and understands that, although the mutual fund is advised by the bank or an affiliate, investments in the fund are not guaranteed by the bank. In addition to the insurance and investment risk disclosures discussed above, if a bank sells shares of a mutual fund advised by the bank or an affiliate, the bank must disclose, in writing, at the time the account is opened, the role of the bank or affiliated company as an adviser to the mutual fund.

Examination of Mutual Fund Activities

In their review of on-premise sales of mutual fund shares during the regular examination of a state member bank, Federal Reserve examiners will assess whether the bank has adequate written policies and procedures in place to ensure that its practices are not misleading, and that mutual fund sales activities are separate and distinct from routine retail deposit-taking activities.

In assessing the adequacy and effectiveness of the bank's policies, examiners will evaluate whether:

1) Disclosure is effective in conveying that mutual funds are not obligations of, or guaranteed by, the bank, the FDIC, or any other agency;

2) disclosure is effective in conveying that mutual fund investments are subject to risk and may fluctuate in value;

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3) disclosure of a bank's or affiliate's advisory role is made when applicable, and whether disclosure is effective;

4) disclosure on periodic mutual fund account statements, confirmations, and promotional material issued by the bank is adequate in conveying that mutual fund investments are not insured by the FDIC or guaranteed by the bank;

5) retail deposit-taking employees of the insured depository institution are prohibited from offering investment advice;

6) the sales area for mutual funds is separate and distinct from the retail deposit area;

7) the bank has a policy to ensure that a third-party conducting mutual fund sales on its premises is issuing disclosures and following procedures comparable to those required for a state member bank conducting this activity.

Examiners will be using the information presented in this letter as general guidance for the review of mutual fund sales activities on the premises of a state member bank. An additional effort is currently underway to coordinate with other agencies to ensure consistency in the supervision of mutual fund sales by banks. It is expected that a detailed policy statement will be issued at a later date which will address these activities more comprehensively. If you have any questions regarding the content of this letter, please contact Donald E. Schmid, Manager, Domestic Banking Department, at (212) 720-6611.

Sincerely,

Chester B. Feldberg
Executive Vice President

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