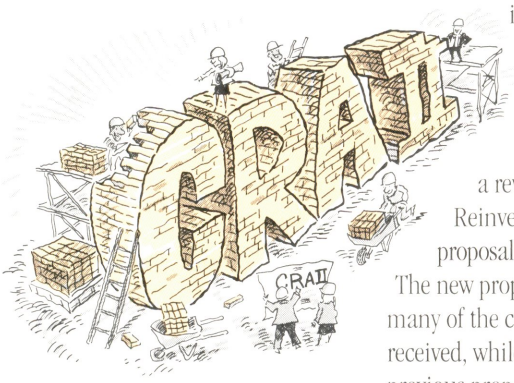
THE FEDERAL RESERVE BANK of ST. LOUIS

CB CENTRAL BANKER

Autumn 1994

News and Views for Eighth District Bankers

Round Two for CRA Reform



After an extended comment period, and after considering more than 6,700 comment letters on the December 1993 proposal, the four federal banking agencies—OCC, FDIC, OTS and Federal Reserve Board—released a revised Community Reinvestment Act (CRA) proposal on September 26. The new proposal addresses many of the comments received, while preserving the previous proposal's emphasis on performance over process. A 45-day comment period for the revised proposal ends November 21. Here are the highlights of the September proposal.

- Like the December document, the revised proposal would eliminate the current regulation's 12 assessment factors, but would retain lending, investment and service tests as the principal measures of performance.
- The proposal would change how a retail institution's ratings on the lending, investment and service tests are combined to produce its overall composite rating. The rating system would require that a bank receive at least a satisfactory rating under the lending test to achieve a satisfactory or better composite rating.
- The proposal would require examiners to use more data in conducting examinations while judging the institution's activity within the context of its abilities and business strategies, as well

(continued on next page)

FAS 115: Fast Facts For Eighth District

Speculation about FAS 115's effect on bankers' investment portfolios began when this accounting rule was passed in May 1993 (see related story on page 5). June call report data from Eighth District banks gives us an early glimpse at FAS 115's fallout. Here's a brief summary.

- At the end of June, 48.2 percent of District banks' investment securities were designated held-to-maturity (HTM), a slight increase from the 46.4 percent share in March.
- The proportion of securities designated available-for-sale (AFS) rose with bank size: District banks with assets of less than $100 million had 48.1 percent of securities in the AFS bucket vs. a 55.2 percent share for banks with assets of more than $1 billion.
- Treasuries and mortgage-backed securities (MBSs) make up almost three-quarters of the AFS portfolio vs. just over half of the HTM portfolio.
- Interest rate increases have taken their toll on both HTM and AFS securities: the market values of the HTM and AFS portfolios stood 1.2 percent and 1.4 percent, respectively, below their book values at the end of June. Not surprisingly, MBSs were the largest decliners.
- Net unrealized losses on AFS securities at June 30 totaled $237.6 million, or 1.7 percent of District banks' equity capital.

Feditorial

A Mission for the Future Payments System

James R. Bowen

For the last four years I have had the opportunity to serve as Executive Director for the Federal Reserve System's payment services (Wire, ACH, Check, Securities). Over this brief period, these services have changed significantly as both the banking industry and the Fed began the movement to a more electronic, consolidated operating environment.

As I step down from this assignment, the future of the payments mechanism promises to be even more dynamic. We, like many financial organizations, are facing the challenge of improving our services and managing them in a new centralized processing environment, while retaining local, personal customer support.

Despite an uncertain future, there is one thing we do know: likely changes and trends in the nation's financial environment will require continued improvements in the payments mechanism. As a result, the Federal Reserve has developed a future-oriented mission—advancing the payments mechanism by eliminating less efficient paper processing and delivery.

A number of issues related to this mission deserve careful thought and attention. It will be imperative that the Fed and bankers work together to accomplish these initiatives for everyone's benefit. Our first task should be to encourage electronic payments of all types ranging from debit cards and electronic "purses" to check presentment, truncation and imaging. Simplification of rules and regulations, new marketing strategies, and incentives should be considered. Second, international payments issues, including risks, formats and interfaces, are with us today and require our attention. Third, a review of electronic data standards and formats with an emphasis on consistency and simplification will be needed. Finally, pricing strategies need to be evaluated to ensure they encourage electronic payment services.

Tackling these issues will not be easy. Challenging your business strategy never is. But now, more than ever before, I think the financial services industry is up to the task.

James Bowen is first vice president of the Federal Reserve Bank of St. Louis.

CRA Reform

(continued from front page)

as the needs of the communities it serves.

- The proposal has modified significantly the use of the market share test. It does not require examiners to use any single type of analysis and would not link a particular market share ratio, or any ratio, with a particular lending rating.
- Based on strong requests from community groups and members of Congress, a borrower's race and gender would now be included when reporting small business and small farm loan data. Consumer data collection would be optional and home mortgage data would be largely limited to the present coverage of the Home Mortgage Disclosure Act (HMDA).
- When evaluating the reasonableness of an institution's loan-to-deposit (LTD) ratio, the 60 percent rule would be eliminated. Instead, an institution's LTD ratio would be considered in light of its size, financial condition and the credit needs of its service area.

Please review the new proposal and forward your comments to the Federal Reserve Board (see *Out for Comment* box on page 4). If you have questions about the proposal, contact Lynn Barry, assistant vice president, at (314) 444-8565 or toll-free at 1-800-333-0810, extension 8565.

Anne L. Beatty

Market Value Accounting: Investment Flexibility vs. Capital Volatility

As many bankers and industry analysts predicted, the adoption of a controversial accounting standard (FAS 115) requiring market value accounting for investment securities has changed the way banks manage their investment portfolios, and could have important implications for the banking industry and economy.

The debate over FAS 115 has focused on the effect that recording investment securities at market values will have on capital measurement. Although advocates have argued that the standard will improve the measurement of equity, bankers and regulators objected because FAS 115 addresses only a single type of asset accounting. These critics claimed that the mismatching caused by ignoring concurrent changes in the value of other assets and liabilities (i.e., loans and deposits) will induce unrealistic volatility in bank capital accounts.

Bankers also argued that they will be forced to engage in inefficient investing activities to mitigate this increase in volatility. They claimed that to reduce volatility in reported equity they will be forced to: 1) hold a lower proportion of their assets in investment securities, 2) reduce the maturity of investments held and 3) sacrifice flexibility in investment portfolio management.

A study of the investment portfolio changes of approximately 250 publicly traded bank holding companies in the quarter that FAS 115 was adopted suggests that bankers' and regulators' concerns about FAS 115 were well founded. This study finds a decrease in both the proportion of assets held in investment securities and the maturity of the investment securities held.

The importance of this accounting change also shows up in the classification of securities after the standard was adopted. Under FAS 115, investment securities not held in the trading account must be classified either as held-to-maturity (HTM) or available-for-sale (AFS). Although market value accounting for HTM securities is not required, such securities can be sold only under very restrictive conditions. HTM securities cannot, for example, be used for liquidity or interest rate risk management. In contrast, AFS securities can be sold at any time, but must be recorded at market value. Changes in the market value of AFS securities will cause volatility in reported equity and capital.

Bankers argue FAS 115 will force them to engage in inefficient investing activities to mitigate increases in volatility.

FAS 115 compels bankers to make a trade-off between maintaining flexibility in investment portfolio management and reducing volatility in reported equity. For the bank holding companies examined in this study, the allocation of securities into these two portfolios was roughly equal as of March 31, 1994. In addition, the proportion of AFS securities was greater for companies with higher average equity-to-asset ratios, net income-to-equity ratios, and portfolio turnover ratios. This suggests that bank managers are willing to incur greater volatility in reported capital to gain flexibility in managing their investment portfolios.

Changes in portfolio management resulting from FAS 115 may have important consequences for the banking industry and for the economy. Shortening the maturity of the investment portfolio may reduce interest income earned by bank holding companies or increase their interest rate risk. Reducing the flexibility to sell securities from the held-to-maturity portfolio may increase the cost of managing interest rate risk and liquidity.

Increased exposure to interest rate changes could make the banking industry more volatile. In addition, less flexibility in liquidity management could prevent banks from meeting increased loan demand, and ultimately result in less credit availability.

In any event, more volatility in financial markets is likely, provided the trends evidenced in this early data continue.

Anne Beatty is an assistant professor of accounting in the Wharton School at the University of Pennsylvania, and a former visiting scholar at the Federal Reserve Bank of St. Louis.

Regional Roundup

OUT FOR

COMMENT

The following are Federal Reserve System proposals currently out for comment:

- **Revised interagency proposal to amend Regulation BB (Community Reinvestment) and related conforming amendments to Regulation C (Home Mortgage Disclosure). Comments due by November 21. (Docket No. R-0822)**
- **Proposed amendments to Regulations H and Y that would modify the definition of the OECD-based group of countries. Comments due by December 14. (Docket No. R-0849)**

Direct all comments to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551.

NICB Proposal Delays Fed Price Announcements

In September, the Federal Reserve Board extended for 30 days the comment period on a proposal to modify the methodology for imputing clearing balance income (NICB). The Board of Governors is expected to act on the proposal along with the 1995 pricing recommendations in early-to-mid November. As a result, the announcement of 1995 Reserve Bank pricing will be delayed several weeks.

The NICB proposal is intended to place the Federal Reserve on more equal footing with private sector banks by matching the investment maturity practices used by bank holding companies.

IRS Realigns Federal Tax Deposit Centers

The Internal Revenue Service recently announced plans to realign federal tax deposit (FTD) processing at IRS service centers throughout the country starting January 3, 1995. The realignment will affect financial institutions designated as Treasury Tax and Loan (TT&L) depositories; they may be assigned to new service centers for TT&L deposits. The new IRS Service Center location for Arkansas, Mississippi and Tennessee institutions will be in Austin, Texas. Indiana institutions will shift to the Kansas City Service Center. Illinois, Kentucky and Missouri institutions will continue to send TT&L deposits to their current service centers. The IRS and Federal Reserve will soon be mailing instruction packets, including advice of credit forms and mailing labels, to financial institutions affected by this realignment.

DORPS Net Debit Cap Increased

The Federal Reserve Board recently approved an increase in the daylight overdraft de minimis net debit cap from 20 percent to 40 percent of an institution's risk-based capital. This new cap level can give you a higher intra-day credit limit and can be implemented after your bank's board of directors approves a resolution to adopt the cap. If you have been contacted about daylight overdrafts recently, you may want to consider adopting a de minimis cap. For more information, call Hillary Debenport at (314) 444-8488 or Daneé Appel at (314) 444-4289.

DORPS Self-Assessment Reminder

Starting with the 1995 self-assessment, institutions must complete two additional analyses. The first analysis focuses on inter-day payment activity, including controlling risks with ACH originations. The second analysis covers operating controls and contingency procedures. For details about the new analyses, see page 49 of your *Guide to the Federal Reserve's Payments System Risk Policy*. For more information, call Hillary Debenport at (314) 444-8488 or Daneé Appel at (314) 444-4289.

Counterfeiters Beware! U.S. Currency to Undergo a Facelift

The Treasury recently announced plans to modernize U.S. currency in a pre-emptive strike against counterfeiters. Potential features will be on the leading edge of technology. In all, more than 12 features are under consideration including: enlarged off-center portraits, a matching watermark, an enhanced security thread in a different location on each bill, expanded use of microprinting, and interactive or moire patterns.

Changes in the size, basic colors, portrait subjects or historical vignettes are not under consideration.

The new security features will allow merchants and the public to more readily identify genuine notes. In addition, covert features, which can be identified by machines, will enhance the banking system's ability to detect counterfeits. The Treasury will not recall, devalue or demonetize any currency. A final design is expected to be approved in 1995, with issuance of newly designed $100 bills in 1996. Smaller denominations will be issued with the new security features some time later.

Legislation Encourages Small Business Loans; Reduces Regulatory Burden

Bankers received a boost to their community development efforts on September 23, when President Clinton signed the Community Development and Regulatory Improvement Act into law. Along with additional funding, the act includes provisions that will reduce regulatory burdens for many financial institutions.

Community development funding was a major portion of this legislation: $382 million will be appropriated over four years to the Community Development Financial Institutions (CDFI) Fund.

Most of the funding will go to special institutions, called CDFIs, that exist to promote community development, serve low-income people or economically distressed communities, and maintain accountability to community residents.

While most banks don't meet the legal definition of a CDFI, many will be eligible to receive funds in the form of FDIC insurance assessment rebates; at least one-third of the $382 million will be distributed to insured banks and thrifts as rebates.

To qualify for the rebates, insured institutions must increase their low-income lending and provide "lifeline" deposit accounts. The act further encourages small business loans by: 1) authorizing insured, federally chartered depository institutions to invest in small business-related securities and 2) preempting state laws to permit others to invest in these securities.

Reducing regulatory burden was also a goal of the CDFI Act. The following provisions are likely to affect Eighth District bankers:

- Exams for institutions with a consolidated exam rating of "good" and assets less than $250 million will be extended to every 18 months instead of every 12 months.
- The Truth in Savings Act has been amended to exclude business accounts and reduce customer lease disclosures in radio advertisements.
- A bank may form a bank holding company (BHC) with a 30-day advance notice instead of an application, if the ownership is not changing, the bank and BHC are adequately capitalized and no non-banking activities are proposed.

Treasury Revises Collateral Valuation Practices

During 1995, the Federal Reserve System and the U.S. Treasury will begin using a new method of determining the collateral value of assets pledged for Treasury Tax and Loan, credit discount or payment system risk.

The effect on most financial institutions should be minimal, as standard adjustments to value are already applied to some securities. Designed to more accurately reflect the current value of certain securities, the new methodology uses either: 1) available market prices (to which margins will be applied) or 2) a uniform valuation system developed by the Reserve Banks to determine collateral values.

Definitive assets will be the first securities subject to the new valuation methodology. Market valuation of book-entry collateral will not be implemented before 1996.

Definitive securities with available market prices will begin using the new valuation methodology on January 1, 1995. During the third quarter of 1995, definitive assets with no available market price will be assigned collateral values using a valuation system developed by the Federal Reserve Banks.

Watch your mail in November for a sample statement showing the value of your securities after January 1.

FedFacts

FCA Reports Now Available

Functional Cost and Profit Analysis (FCA) annual reports can assist you in developing a budget plan, pricing services or measuring your performance against your peers. The following four reports, costing $100 each, are compiled from data supplied by participating financial institutions: *National Average Report for Commercial Banks, Eighth District States Report for Commercial Banks, National Average Report for Credit Unions, and National Average Report for Thrifts.*

To purchase one or more of these reports or to ask questions about FCA, contact Flora Armon or John Lorentz at (314) 444-8667 or (314) 444-8322, respectively. You can also reach Flora or John toll-free at 1-800-333-0810, extension 8667 or 8322, respectively.

St. Louis Announces Low-Cost City Group Sort

Bankers can now collect a select group of city endpoints for only $0.009 per item. The St. Louis office's new city payor group sort allows you to deposit checks drawn on 14 city institutions at 10:30 a.m. for same day credit. For the standard cash letter fee of $2.00 and a low per-item fee, this group sort helps you reduce your sorting requirements and save on operating costs and service fees. For a list of institutions included in the group sort, call Customer Support toll-free at 1-800-333-0869 or locally at 444-8680.

New Deposit Options Introduced in Memphis

Looking for ways to reduce your check collection costs in the Memphis zone? Try one of the three new group sorts available through the Memphis branch of Fed St. Louis. You can now deposit checks drawn on a select group of 22 Arkansas RCPC banks, 22 Mississippi RCPC banks, and 40 Tennessee RCPC banks in separate cash letters for only $0.01 per item and a $2.00 cash letter fee. Depositors outside the Memphis zone add $1.00 to the cash letter fee.

You have until 3:00 a.m. to deposit checks and receive same day credit on all items. As a bonus, U.S. Treasury checks, postal money orders, and E-Z Clear savings bonds may be included in any of these cash letters for the same low price. To obtain a detailed listing of the group sorts, contact Travis Smith at 1-800-238-5293 (Arkansas and Mississippi) or 1-800-552-5132 (Tennessee). Depositors located in other states should call Customer Support at 1-800-333-0869.

Calendar

1995 Legal Holiday Schedule for the Eighth Federal Reserve District

Day	*Date*
Monday	January 2
Monday	January 16
Monday	February 20
Monday	May 29
Tuesday	July 4
Monday	September 4
Monday	October 9
Thursday	November 23
Monday	December 25

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Post Office Box 442
St. Louis, Missouri 63166

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