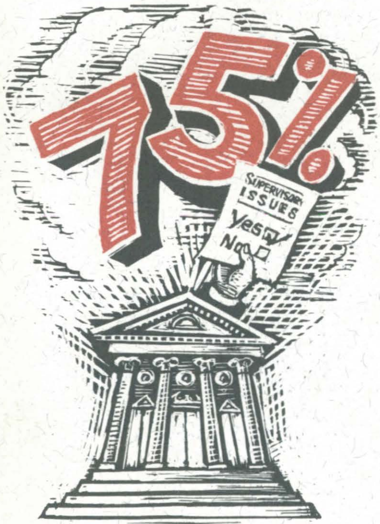
THE FEDERAL RESERVE BANK of ST. LOUIS

# SUPERVISORY ISSUES

July 1992

Supervisory News and Views for the Eighth District

# Introducing *Supervisory Issues*... from the St. Louis Fed




This is the first edition of *Supervisory Issues* — the newsletter you requested! When surveyed earlier this year, nearly 75 percent of District bank respondents asked for a Federal Reserve publication devoted to brief synopses and analyses of supervisory and regulatory matters. (See story below for more survey results.)

Published bimonthly by the St. Louis Fed's Division of Banking Supervision and Regulation, *Supervisory Issues* will provide bankers with information on proposed and final regulations and policy guidelines. Included will be suggestions from Federal Reserve examiners that should clarify examination expectations.

We recognize the challenge District banks face in understanding and achieving compliance with new statutes and regulations mandated by Congress; we hope this newsletter can help. In addition, we will include analyses of trends in District bank performance.

**This issue is being sent to banks and bank holding companies who received our earlier survey; we welcome any additions to our free subscription list.**

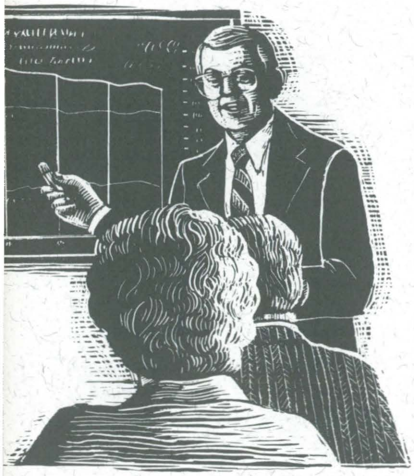
## Survey Respondents Request More Regulatory Guidance

We received a strong response to the survey we sent to all banks and bank holding companies in the Eighth District earlier this year. Almost 30 percent of those surveyed took the time to comment on ways we could improve communication of supervisory and regulatory information. We were encouraged to learn that most respondents read some or even all of the material we provide. In addition, a majority of respondents, regardless of charter or regulator, look to the St. Louis Fed for supervisory and regulatory guidance. And, most of you asked for more guidance on examination expectations and regulatory compliance.

To meet this request, our Banking Supervision and Regulation Division will establish new or expanded programs to share information throughout the District. These programs include this newsletter, educational seminars, and an expanded telephone "hot line" service. In addition, we are investigating better ways to distribute critical information to you in a timely manner. Your survey responses provided direction for the supervisory information program for the Eighth District.

The survey also disclosed, however, that only 10 percent of respondents comment on proposed regulation changes. As an article later in this issue indicates, Eighth District banks are passing up opportunities to share their concerns with the Federal Reserve and to affect the supervisory policies with which they must comply.

# Disclosure Requirements and Lending Limits: Some Supervisory Guidance on Regulation O



Recent amendments to Regulation O became effective on May 18, 1992. Given the complexity of the changes and the number of inquiries we have received to date, we have written this article to help clarify some of the main points of the revised regulation. Specific guidance on how these changes will be viewed during examinations is also given.

## New Lending Limits

With revisions to the Federal Reserve's Regulation O now in effect, bank managers must ensure they comply with new disclosure requirements as well as the aggregate lending limit to insiders and the individual limit now applicable to directors. For state non-member banks, steps must also be taken to ensure compliance with the lending restrictions on loans to executive officers, which previously applied only to state member banks.

The aggregate lending limit for loans to all insiders and their related interests – 100 percent of the bank's unimpaired capital and surplus – is the sum of total equity capital and any valuation reserves of the bank, as reported on the most recent consolidated Report of Condition (outstanding capital notes may also qualify for inclusion). Banks with deposits of less than $100 million may, under certain circumstances, adopt an aggregate limit up to 200 percent of this amount.

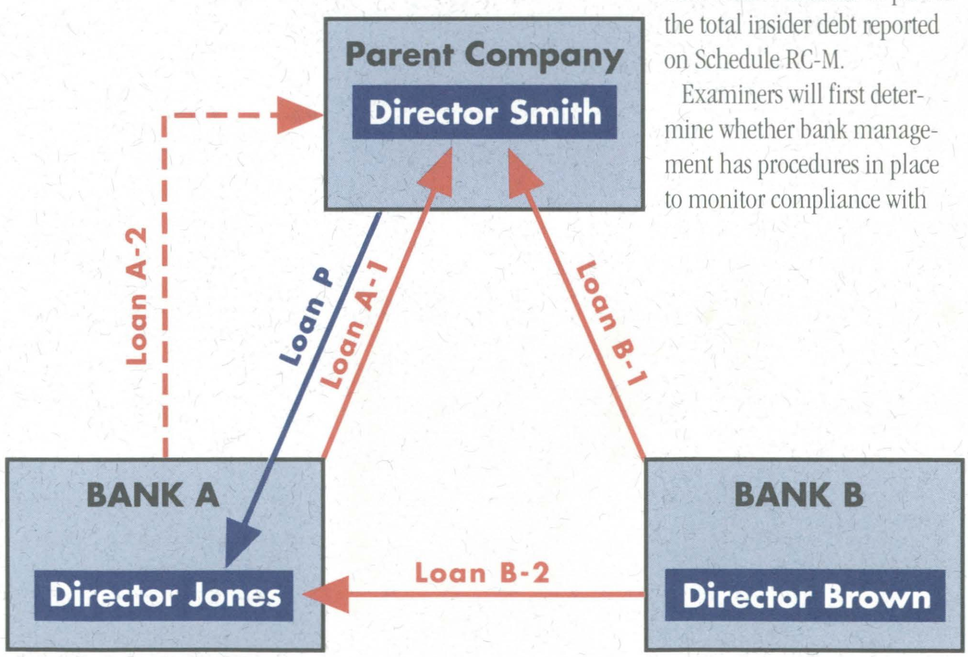
For loans to directors and their related interests, Reg O adopted the same lending limit that previously applied to principal shareholders and executive officers of member banks – 15 percent of unimpaired capital and surplus for unsecured loans and an additional 10 percent for secured loans. If state lending limits are more restrictive, however, they must take precedence.

**Bank examinations will be the primary method the Fed will use to determine compliance with the new lending limits.**

Bank examinations will be the primary method the Fed will use to determine compliance with the new lending limits. The Report of Condition will also likely be amended to include loans to directors and their related interests as part of the total insider debt reported on Schedule RC-M.

Examiners will first determine whether bank management has procedures in place to monitor compliance with

**Loans Included in Aggregate Lending Limit**




*Loans A-1 to Director Smith and A-2 to the Parent Company must both be included in Bank A's aggregate lending limit. Loans B-1 and B-2, both to directors, must be included in Bank B's aggregate lending limit. Loan P is not included in any aggregate limit.*

the lending limits. The bank's unimpaired capital and surplus will then be calculated from the most recent Report of Condition. The total amount of outstanding credit to insiders and the amount outstanding to individual directors will be determined by reviewing agency-specific forms which currently request this information, such as the Officer's Questionnaire used by the Federal Reserve Bank. This is the same method currently used to determine compliance with the lending limits for executive officers and principal shareholders.

**When monitoring and disclosing the total amount of insider lending, certain extensions of credit must not be overlooked.**

When monitoring and disclosing the total amount of insider lending, certain extensions of credit must not be overlooked. Credit extended to parent holding companies and non-bank affiliates as principal shareholders must be included, although the Federal Reserve Board has indicated it intends to seek legislative relief on this issue.

Loans to executive officers, directors and principal shareholders at parent holding companies and subsidiaries of the parent company must also be included in the total amount since these individuals are defined as insiders of the bank. The individual lending limit now applicable to directors must also be applied to extensions of credit from the bank to directors of these institutions.

In determining the aggregate amount of credit that may be extended to all insiders, extensions of credit that are exempt from the individual loan limits, such as credit secured by obligations of the United States, should be included. Extensions of credit to insiders of the bank from a *subsidiary* of that bank must also be included in both the aggregate amount and individual loan limits.

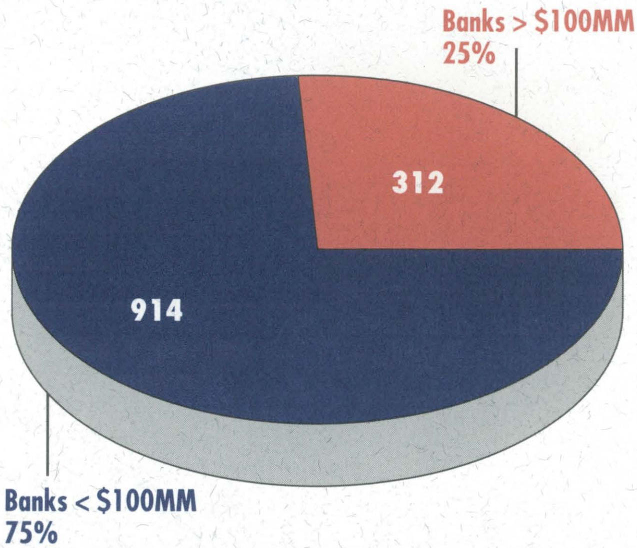
## Small Bank Exemption

For small banks that adopt a higher aggregate lending limit, the examination will also focus on whether statutory requirements have been met. The bank's board of directors must first determine whether a higher limit is consistent with safe and sound banking practices based on the bank's experiences with insiders and their related interests.

The board must also determine whether a higher limit is necessary to avoid constricting the availability of credit or directors in that community. While the regulation is silent on exactly how to determine this, factual support for the finding is necessary. Statements from directors or other business leaders in the community are one method, as is information about the amount of lending by the bank to its directors and related interests.

If the board of directors makes these findings and the bank meets all applicable capital requirements, a higher limit may be adopted by board resolution for the one-year period allowed by the Federal Reserve Board, ending May 18, 1993. The resolution must include the facts and reasons support-

**Eighth District Banks Eligible For Exemption (as of March 31, 1992)**




***75 percent of all Eighth District banks, a total of 914, report deposits of less than $100 million, making them eligible for the small bank exemption under the revised Regulation O.***

ing both of the findings above and the amount of insider lending as a percentage of the bank's unimpaired capital and surplus. After adoption, it must be submitted to the bank's federal regulatory agency and the Federal Reserve Board.

**The board must determine whether a higher limit is necessary to avoid constricting the availability of credit or directors in that community.**

## Revised Reporting Requirements

Both executive officers and directors of banks and bank holding companies without publicly traded stock must now report annually to their institutions the outstanding amount of any credit extended to them that is secured by shares of the bank or the bank holding company. Guidance from the Federal Reserve Board on the definition of publicly traded stock is expected before year-end. Managers of institutions in this category should advise their officers and directors of this requirement and maintain records from which examiners can determine compliance.

Other than the above, only executive officers are now affected by additional reporting requirements. For state nonmember banks, special reporting and documentation provisions about their loans to executive officers now apply; in the past, they applied only to state members. Additionally, *all banks* need to ensure their loan documents include a condition that extensions of credit to executive officers will, at the option of the member bank, become due and payable if the officer becomes indebted to another bank in amounts exceeding the loan limits.

# Your Comments Do Count

In a recent Eighth District survey, only 10.4 percent of the respondents indicated that they routinely comment on proposed regulation changes. One of the primary reasons cited for this apparent lack of interest in the comment process was "why bother, they don't listen anyway." The Federal Reserve Board recently showed, however, that it does listen, as evidenced by a key change made when implementing the revised Regulation O.

The Board received 268 written comments on the proposed changes to this regulation, primarily from community and independent banks. Overwhelmingly, the commentors requested that the Board raise the lending limit to insiders and their related interests up to 200 percent of the bank's unimpaired capital and unimpaired surplus for banks with deposits less than $100 million. The authority to exercise this decision was granted under FDICIA (Federal Deposit Insurance Corporation Improvement Act of 1991).

Respondents argued that the lower aggregate limit would restrict them from serving the credit needs of their directors and the directors' related interests. This would force current or prospective directors to choose between being a director or a customer. In turn, a small bank would be deprived of either strong, informed leadership or a valuable customer relationship.

As a direct result of these comments, the Board granted a one-year exception to the lending limit for small banks. The Board chose this one-year exception to analyze the effects of the lending limitation on the ability of these banks to attract qualified directors and serve their credit needs.

Thus, the next time you are asked to comment, please be sure to give it serious thought before passing up the opportunity to be heard.


### Upcoming Opportunities to Comment on Proposals

*The following proposals implementing the Federal Deposit Insurance Corporation Improvement Act (FDICIA) are expected out for public comment in the coming months. Watch for these opportunities to have your comments heard.*

- A proposal to require the adoption of regulations for real estate lending;
- The adoption of safety and soundness standards for banks and BHCs in the areas of operations; asset quality, earnings, and stock valuation; and compensation;
- Proposed regulations that provide a format for closer monitoring of institutions and prompt corrective action when an institution begins to experience difficulty;
- The adoption of standards for measurement of interest rate risk.

## These Comments Just In...

The proposed Regulation DD, Truth in Savings, was also recently sent out for comment. As of the end of the comment period on June 10, more than 1,400 comments had been received by the Federal Reserve Board.

The topics most commonly mentioned included disclosure requirements for CDs which renew automatically, notification requirements for adverse changes to loan rates or terms, and disclosure requirements for advertising.

The final regulation will be published by September 19, 1992. More information on this regulation will be distributed as it becomes available.

# BANK PERFORMANCE

## District Bank Performance Up in 1990 and 1991

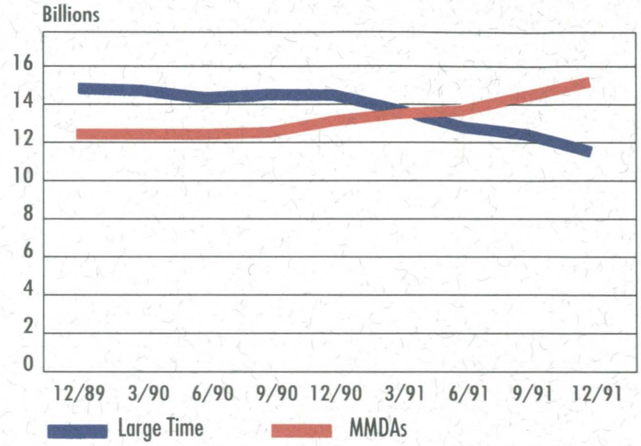
### Some Background on District Banks

*Aggregate banking assets for the District's 1,238 banks as of year-end 1991 were $145.3 billion or about 4 percent of the total U.S. banking assets. District banks consist primarily (79.5 percent) of small community banks with less than $100 million in assets.Only 14 banks in our District have total assets greater than $1 billion.*

The performance of Eighth District banks displayed several positive trends during 1990 and 1991. First, District banks maintained stable income streams while restructuring balance sheets. Second, these earnings were not achieved at the expense of reduced provision expense. Finally, District banks experienced appreciable asset growth of 10.5 percent which was surpassed by equity growth of 12.3 percent.

Income remained stable over the two-year period while banks restructured both sides of the balance sheet. During 1991, as short-term interest rates declined, the liabilities side showed that bank deposit structures moved from larger time deposits to shorter-term instruments such as MMDAs (money market deposit accounts). On the asset side, loan growth slowed to .71 percent while investment securities grew by 13.7 percent. (See charts.)

**Large Time Deposits vs. MMDAs**



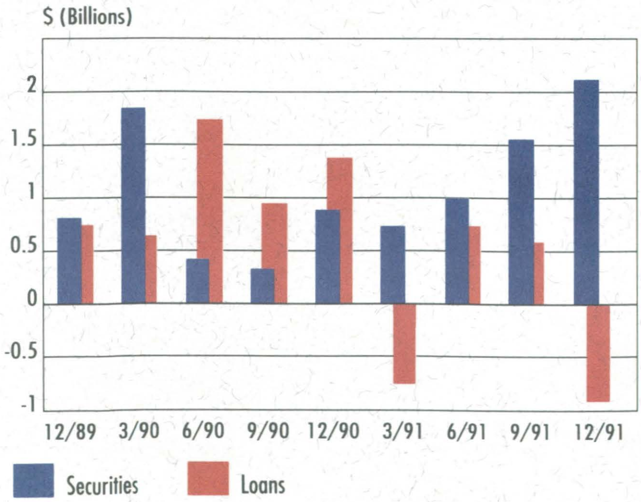

Despite this repositioning, earnings remained stable. Even though net earnings peaked in the third quarter of 1990, the ROAA (return on average assets) only declined by a maximum of 10 basis points throughout the two-year period. In addition, the net interest margin remained stable.

Earnings stability was not achieved, however, by lowering the provision expense. Even though the District experienced modest increases in both the level of nonperforming loans and the level of loan losses, the increases were accompanied by a marked increase in District loan loss reserves. During 1991, coverage of nonperforming loans increased by 16.6 percent, resulting in an overall coverage ratio exceeding 100 percent by year-end.

The final significant positive trend over the past two years is that the Eighth District asset base grew by 7.1 percent in 1990 and an additional 3.4 percent in 1991. Asset growth was enhanced by the acquisition of deposits transferred to District commercial banks from failed thrift institutions in each year. Of even greater importance is the fact that equity growth surpassed asset growth by 180 basis points over the period. The increased equity provides additional strength for District banks.

In summary, District banks entered 1992 better positioned to maintain consistency in earnings, manage nonperforming loans in their portfolios and continue a pattern of asset and equity growth.

**Investment Securities/Loan Growth**
Quarterly Dollar Change

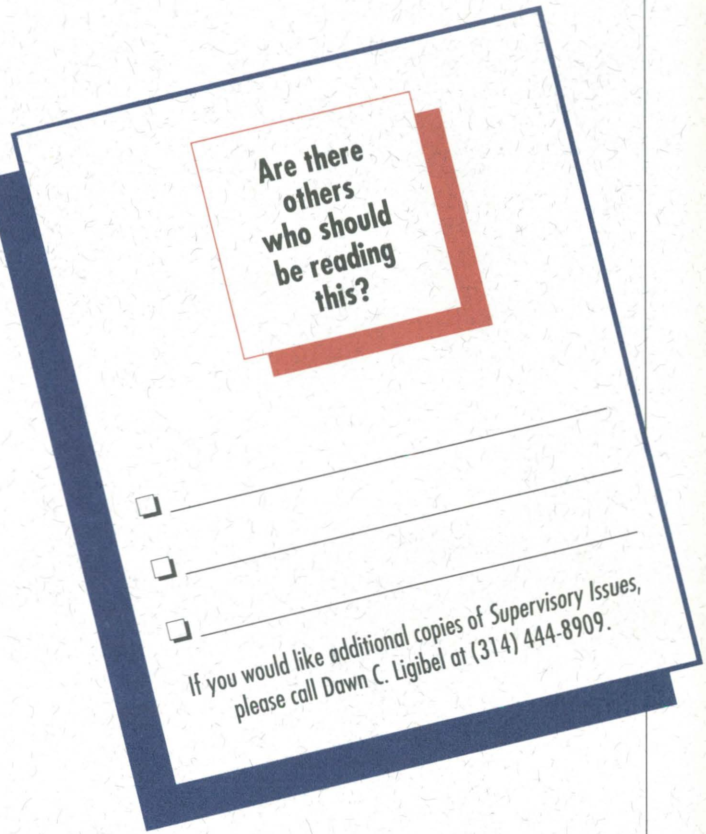


# Reducing The Regulatory Burden: An Update

Since the late 1970s, the Federal Reserve has had formal programs in place to review both regulatory and reporting requirements regularly to minimize the burden on banks and holding companies. The current interagency regulatory uniformity project announced April 23, 1992, placed renewed emphasis on a dozen projects already under way. Among those areas now being addressed through Reserve Bank and Federal Reserve Board working groups include:

- coordinating examinations and inspections with both federal and state regulators,
- clarifying common approaches toward classifica tions and accounting treat ment of certain assets,
- developing application forms common to federal regulators,
- limiting the frequency of call report changes, and
- working toward a common and pragmatic approach on guidelines for the loan loss reserve.

We will keep you informed as these groups progress.




## Got a Question?

The Banking Supervision and Regulation Division recently mailed a phone listing of whom to call when you have a question to all banks and bank holding companies in the Eighth District. If you would like additional copies of the phone card, please call Dawn C. Ligibel at (314) 444-8909.

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