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THE FEDERAL RESERVE BANK of ST. LOUIS

September 1992

SUPERVISORY ISSUES

Supervisory News and Views for the Eighth District

Fed and CSBS Encourage Alternative Examination Agreements

On September 9, the Federal Reserve Board of Governors and the Conference of State Bank Supervisors executed a joint resolution encouraging cooperative examination agreements between Federal Reserve Banks and state banking departments. This resolution formalizes the Fed's long-standing practice of close cooperation with state banking supervisors.

Begun in 1981, the Fed's alternate examination program now includes 36 states, representing 96 percent of all state member banks, which participate either formally or informally. The resolution asks each Reserve Bank, where they have not already done so, to work with state banking departments to develop procedures that provide for alternate examinations on a 12-month basis.

Since 1981, the St. Louis Fed has had an alternate examination agreement with the Commissioner of Finance in Missouri. In addition, it has informal arrangements with state banking supervisors in Arkansas, Kentucky, Illinois, Indiana and Mississippi under which the Reserve Bank accepts state examinations of banks in satisfactory condition to meet Federal Reserve frequency guidelines.

Coordination efforts also extend to bank holding company supervision. In those instances where a state member bank is the only subsidiary of a bank holding company, the bank examination and holding company inspection are conducted concurrently. Inspections of multibank holding companies are normally coordinated with an examination of the lead bank within the organization, whether the examination is conducted by a state or federal banking agency.

Through these coordinated efforts, both Reserve Bank and state bank supervisors are able to assess accurately the condition of the entire banking organization and focus examiner resources on those institutions that pose the greatest risk to the deposit fund.

Subordinated Debt Limitations Clarified

The Federal Reserve Board of Governors recently issued an interpretation of the capital adequacy guidelines concerning subordinated debt issued by bank holding companies and state member banks. The interpretation was effective September 4 and clarifies the manner in which subordinated debt must be structured to qualify as Tier 2 capital. The interpretation ensures that holders of debt qualifying as capital will not be permitted, by the terms of the instrument, to demand payment when the issuer is experiencing financial difficulties and is unable to pay without endangering its financial viability. Debt that has many commonly employed

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FDICIA Implementation: What's Next?

Proposed regulations implementing the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) have been published for comment this past summer. In July, federal banking agencies issued notices of proposed rulemaking with respect to prompt corrective action for undercapitalized institutions, certain minimum safety and soundness standards, standards for prudent real estate lending and limitations on interbank liabilities. These were followed in early August by a proposal to revise risk-based capital guidelines to incorporate interest rate risk. A chart reflecting the status of regulations being issued in final form between now and year-end appears below.

Subject	**Status**
Prompt Corrective Action Final uniform regulations by each banking agency implementing for all depository institutions a system of prompt corrective action established by FDICIA. The regulations will define capital zones using a leverage ratio and a risk-based capital ratio, establish mandatory and discretionary supervisory actions applicable to institutions in those zones, and establish procedures for issuing and contesting prompt corrective action directives.	Final regulations issued in September to be effective December 1992.
Interbank Liabilities Final regulation to be issued by the Federal Reserve prescribing standards to limit the risks posed by an insured depository institution's exposure to another depository institution. The regulation will require depository institutions to develop and implement internal procedures to evaluate and control exposure to the depository institutions with which they do business and set limits on both credit risk and settlement exposure to each individual correspondent.	Final Regulation F applying to all depository institutions to be issued soon to be effective December 1992.
Independent Audit Committee Insured depository institutions with assets more than $150 million must have an audit committee made up of directors independent of management. In larger institutions (to be defined by regulation) the members must be persons with banking or related financial expertise, have access to the committee's own independent counsel and may not include large customers of the institution.	Statutory provision to be effective January 1993. FDIC will prescribe regulations.
Truth in Savings Final regulation issued by the Federal Reserve implementing disclosure requirements for new and existing deposit accounts, and prescribing formulas for computing the annual percentage yield (APY) and other terms. In addition, the regulation sets rules for advertisements of deposit accounts and a notice period before the effective date of any adverse change in the terms of an account.	Final regulation issued in September to be effective March 1993.
Real Estate Lending The federal banking agencies have proposed uniform real estate lending standards for depository institutions. The proposed standards prohibit extensions of credit that do not meet the requirements of the regulation.	Final regulation to be issued before year-end and to be effective no later than March 1993.

Transaction Limitations in Savings and MMDA Accounts: Suggestions for Compliance

Changes to the limitations on savings account transactions have added to the complexity of account restrictions. Unfortunately, such changes have been followed by a marked increase in the number of violations of Regulation D (Reserve Requirements of Depository Institutions) noted in recent consumer compliance examinations.

The most frequent violation is an excessive number of transactions between accounts or to third parties in both money market and traditional savings accounts. An analysis of these violations by Fed examiners suggests that deposit accounting systems may not reflect and monitor the limitations, and that bank customers may not fully understand them.

Both accounts now limit customers to six transfers and withdrawals between accounts in the same institution, or to third parties each month or calendar statement cycle. Only three of the six transfers may be third-party payments by check, draft or debit card.

Certain transactions, however, are exempt. Transfers or withdrawals made by mail, messenger, automated teller machine (ATM) or in person do not count toward these limitations. A transfer by telephone is not exempt, however, unless it is a request for the bank to withdraw funds and mail a check to the depositor. All preauthorized transfers to another account of the same customer or to a third party are subject to the six transaction limitations.

Banks have two ways to ensure compliance. The first is to establish limits in the bank's deposit accounting system to prevent transactions that exceed six each month. The other approach is to adopt procedures to monitor activity ex post. Under either approach, banks must be able to distinguish the method of transfer or withdrawal.

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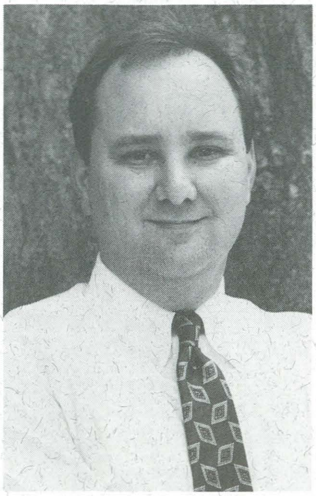
Banks that choose to monitor ex post are expected to notify customers who regularly exceed the limits. Notifying the customer by phone or letter may not be enough, however. If a customer continues to exceed the limits after notification, the bank must either close the account and transfer the remaining funds to a transaction account or withdraw the transfer capabilities of the account.

If a bank's monitoring system discloses a large number of transactions that exceed the limitations, it is likely that customers do not understand the transaction limitations in the accounts. New accounts representatives can help by directing customers to the type of account that best meets their transaction needs. When a customer exceeds the limits, the bank should include a brochure or written explanation of the account with the exception notice. If customers are aware of account provisions and the consequences of repeatedly exceeding account limitations, they are more likely to comply.

In planning its deposit products, a bank should take into account its deposit accounting and monitoring capabilities when it determines the number of and type of transactions permitted in each of its deposit accounts. (The limitations on savings accounts are described in Paragraph 204.5 of Regulation D.)

Banking on the Fed: One Examiner's View

Changes in technology and new credit and investment products are transforming the way bankers do business and, correspondingly, the way bank supervisors examine banks and bank holding companies. In addition, concerns about credit availability and regulatory changes mandated by FDICIA are increasing both public and industry scrutiny of the historically low-profile bank examiner.



Gary J. Juelich

Despite these challenges, according to Gary Juelich, a St. Louis Fed examiner, "It's a great job. No two days are the same." Juelich's 17 years of experience are typical of the Fed's senior examiners and includes a diversity of assignments. For example, Juelich has served as examiner-in-charge of examinations of several community banks, participated in the review of commercial and real estate credits during the Shared National Credit Program, assisted in holding company inspections and led an examination of a troubled institution which led to a determination of insolvency.

According to Juelich, the most critical challenge faced by examiners is to identify credit risk while there is still time for the banker to minimize losses. While the core of an on-site examination has changed little, examiners now spend more time analyzing information between on-site visits. This includes reviewing a bank's efforts to improve criticized assets and correct law violations as well as its plans to address weaknesses in underwriting standards and internal controls.

When asked how he handles disagreements with bankers, Juelich said simply, "With experience, you learn to trust your instincts. We approach each examination with an open mind and are always willing to listen to the bank's position on any issue. Exposure to many banks of varying size and market orientation has taught me that no single approach works for all banks; each has unique characteristics that need to be considered."

Concerns about credit availability and regulatory changes are increasing both public and industry scrutiny of the historically low-profile bank examiner.

Staying abreast of industry changes is also a challenge. As margins narrow and competition increases, bankers seek new profit sources that examiners have to evaluate. Additionally, as regulations affecting banks change and increase in complexity, examiners have to apply them on the job. To keep up, examiners spend more time in school.

Within the past year, Gary taught one of the Board of Governors' credit analysis schools required of commissioned examiners and then became a student himself for several weeks at graduate banking school.

Though examiner resources are stretched, the Fed continues to perform full-scope examinations at all banks, regardless of the size. "The duration and emphasis of each examination varies with size, complexity, and financial condition," Juelich explained. "But we believe that every aspect of the bank needs to be considered to assess its true condition."

Juelich sees this as a benefit for member banks. "If I were a senior bank official or director, I would welcome the Fed's approach. I would want to know that the condition of the bank is being accurately reflected and be aware of any adverse conditions that may be emerging while there's still time to correct them."

Bank Performance

The District's Investment Portfolio Grows

One of the most apparent trends in quarterly District banking statistics is the substantial increase in the investment securities portfolio. Throughout 1991, as loan demand weakened and continued sluggish, banks invested more of their assets in securities. The banks' aggregate securities portfolio has expanded by 21.3 percent in the last five quarters, with the growth rate increasing each quarter (see chart below). On March 31, 1992, investment securities made up 30.8 percent of District banks' assets.

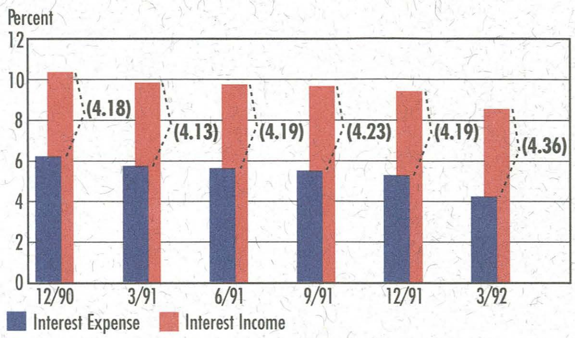
A closer look at the investment securities portfolio reveals that U.S. government agency securities account for 50 percent of the total. When the U.S. Treasury segment is added, the two components account for 79 percent of the portfolio. These categories were also the fastest growing during the period.

Minimal change was observed in the maturities distribution and securities mix. There was a slight increase in the nearest-term securities during the last two quarters. And the mix of fixed vs. variable rate securities changed only slightly. Most of the securities in the portfolio are fixed-rate securities with maturities greater than one year.

As short-term interest rates declined during 1991, corresponding yields on securities receded as expected. Despite such declines and despite banks investing more funds in securities, the net interest margin showed no adverse effect primarily because of much lower interest expense (see chart above). District interest expense dropped by 152 basis points during the five-quarter period ending March 31, 1992. Meanwhile, interest income declined by only 129 basis points, bolstering the net interest margin. The fact that only 11 percent of the banks' securities portfolio matured in each quarter protected the yield from substantial declines. In the present environment, banks face the challenge of balancing interest income and expense if interest rates continue to decline, putting additional pressure on the margin.

Interest Income vs. Interest Expense

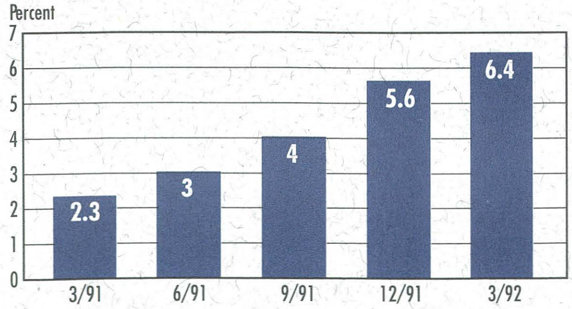
(As a Percent of Average Earning Assets)



Net Interest Margin Shown in Brackets Adjusted for Tax Equivalency

District Securities Growth

Quarterly Trend



Subordinated Debt Limitations

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acceleration clauses will no longer be included in capital.

To qualify as Tier 2 capital under the risk-based capital guidelines, subordinated debt must now meet the following criteria.

- It must be subordinated in right of payment to the claims of the issuer's general creditors and, for banks, to the claims of depositors as well;
- It must be unsecured and have a minimum average maturity of five years;
- Acceleration clauses must be limited to those that permit debtholders to accelerate payment of principal in the event of bankruptcy or appointment of a receiver for the issuing organization; and
- It must not contain any covenants, terms or restrictions that are inconsistent with safe and sound banking practices.

Acceleration clauses that will exclude an issue from qualifying as Tier 2 capital include those that permit debtholders to accelerate repayment if the issuer fails to make scheduled principal or interest payments, defaults on any other debt, or fails to honor financial covenants such as those which specify capital ratios or maintenance of a minimum amount of capital.

Examples of provisions that are inconsistent with safe and sound practices include covenants that do not allow additional borrowing or prohibit a banking organization from selling a major subsidiary or undergoing a change in control.

While there is no transition period to implement this interpretation, subordinated debt issued prior to September 4 may continue to qualify as Tier 2 capital as long as the terms of the issue have been commonly used by banking organizations and do not provide an unreasonable degree of protection for the holder.

Outstanding subordinated debt with provisions referring to capital ratios or other financial performance measures that permit the holder to accelerate payment of principal when the organization begins to experience financial difficulties, however, will no longer be included in Tier 2 capital.

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