RESEARCH LIBRARY
Federal Reserve Bank
of St. Louis

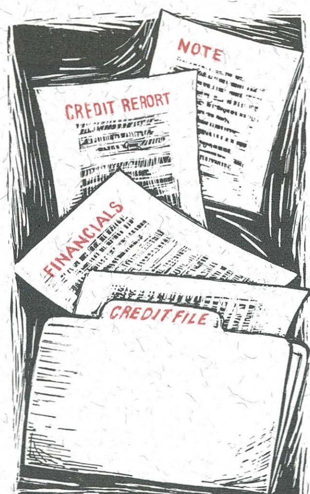
MAR 1 8 1993

March 1993

Supervisory
News and Views
for the Eighth District

SUPERVISORY ISSUES

Why Examiners Emphasize Loan Documentation



Experience and judgment of seasoned credit officers remain the primary requisites for sound loan portfolios. Accordingly, lenders who know their customers and territories will prove the old axiom that all loans are good loans when they are booked.

Documentation of the loan process, however, becomes important when the unexpected happens and it becomes necessary to demonstrate to others that an informed credit decision was made. Directors, loan reviewers, internal and external auditors, and examiners have an obligation to judge the value of a loan without the benefit of direct contact with the borrower.

This is primarily why Fed examiners look for an effective system to maintain complete and current information on borrowers. The following information provides specific guidance to clarify the expectations examiners have when reviewing loan portfolios.

What should loan documentation tell you?

Loan documentation should reveal why money is being borrowed, for how long and at what price. Good credit files document a primary and, if secured or guaranteed, a secondary source of repayment. For secured loans, the pledged collateral will be identified and assigned a realistic value and the bank's lien position will be documented.

Also, periodic analyses of a borrower's financial statements enable the lender to monitor the borrower's repayment capacity and can identify emerging cash flow deficiencies before the loan becomes delinquent.

(continued on next page)

Last Minute Reminders for Filing the FR Y-6

All bank holding companies with a fiscal year ending December 31 should be aware that the Annual Report of Bank Holding Companies (FR Y-6) is due no later than March 31. To assist you, examiners have developed a list of common errors noted during the review of these reports. Before mailing this year's report, take a few moments to review the following list to ensure that your report is accurate and complete.

1. Provide a complete response to each item and sub-item in the report, even if the response is "not applicable."

The following items are most commonly left blank:

- Item 4, Amendments to Organizational Documents
- Item 7, Insider Loans
- Item 8, Changes in Investments and Activities

When responding to Item 8, either sign the confirmation statement included in the report instructions or retype and sign a new statement. Sign a statement even if

(continued on next page)

Digitized for FRASER
https://fraser.stlouisfed.org
Federal Reserve Bank of St. Louis

Documentation

(continued from front page)

What do examiners expect to see in a credit file?

This varies depending on the type of loan. The following list identifies typical items required for *any* type of loan:

- borrowing resolution, for corporations
- loan application
- credit check or analysis of credit history
- promissory note or other agreement evidencing indebtedness
- current balance sheet, income statement and cash flow statement

If a loan is secured by personal property, the following should also be included:

- security agreement
- UCC-1 filing
- receivables aging, if included in collateral
- periodic inspection of movable collateral
- titles to vehicles
- estimate of collateral value
- collateral release certificate, as applicable
- hazard insurance policy, as applicable

If the loan is secured by real estate, the following documents should be added to the file:

- qualified appraisal
- deed of trust or mortgage
- title insurance policy or attorney's opinion
- hazard/liability insurance policy
- environmental study, as applicable
- lien waivers for construction loans

Examiners are obligated to judge loans without the benefit of borrower contact.

Finally, if the loan is guaranteed, include the following:

- guarantee agreement
- current financial statements on guarantors

Although these lists are not all-inclusive, they emphasize the importance of creating files that support the credit. Loans with these and other items missing are noted in the examination report as "Loans Not Supported by Proper Documentation."

To avoid having documentation exceptions mentioned in examination reports, credit officers should have systems in place to ensure that all necessary documents are maintained in the loan files.

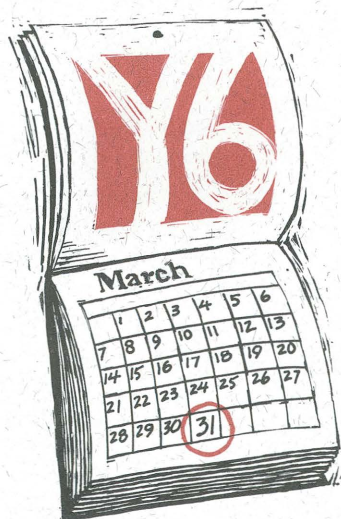
Filing the FR Y-6

(continued from front page)

you do not need to file a Bank Holding Company Report of Changes in Investments and Activities (FR Y-6A). This verifies that the holding company either has no change in activities or has reported all required changes on the FR Y-6A.

Item 6 is often incomplete. If a director or officer has another principal occupation, other than with the holding company, list the occupation. Also disclose information on each director's or officer's holdings within the organization and other business companies.

Item 3 is also often left incomplete. Be sure to indicate all direct and indirect subsidiary ownership relationships, including the percentage of ownership. Even if a subsidiary is inactive, it should still be on the chart.



2. File *two-year* comparative financial statements, including a balance sheet, income statement, statement of changes in stockholders' equity and cash flow statement.

Companies with more than one subsidiary bank or total consolidated assets of $150 million or more are also required to file these comparative statements on a consolidated basis. Additionally, companies that own non-bank subsidiaries must submit a two-year comparative balance sheet, income statement and statement of changes in stockholders' equity for each of these subsidiaries.

Do not send a statement of changes in financial position as a substitute for the cash flow statement or copies of the FR Y-9 series reports. Neither of these meet the reporting requirements for the FR Y-6.

3. Sign the cover page and mail the appropriate number of complete copies with the original report.

Normally, the original plus two copies are required. If the company's total consolidated assets are $500 million or more, however, send the original plus three copies.

4. Mail or deliver the report in time for it to reach the Federal Reserve Bank on or before March 31, 1993.

If the reports are not received by the deadline, they must either be postmarked no later than March 28, 1993, or entered into an overnight delivery system no later than March 30, 1993. Please remember that extensions for filing reports will be granted only in exigent circumstances.

If you have questions regarding the FR Y-6, please call Rita J. Rauba at 314-444-8850 or Eugene J. Knopik at 314-444-8438.

Digitized for FRASER
https://fraser.stlouisfed.org
Federal Reserve Bank of St. Louis

Answers to Common Regulation O Questions

Bankers continue to call this Reserve Bank with questions on Regulation O, which was amended in May 1992. Therefore Fed examiners and attorneys developed a question and answer booklet to help bankers comply with the new requirements. The following excerpts from this booklet highlight some of the changes and more complex issues.

What is the individual lending limit?

The amount a bank may lend to an individual insider is limited to 15 percent of the bank's unimpaired capital and surplus for loans that are not fully secured and an additional 10 percent for fully secured loans.

State chartered banks, however, are subject to the lower of this limit or the lending limit of their state. The individual lending limit incorporates the limits and exceptions of the concentration of credit rules under the National Bank Act.

Are loans to directors now subject to the individual lending limit?

Yes. Loans to directors and their related interests are now subject to the general individual lending limit applicable to executive officers and principal shareholders. There are, however, additional restrictions on loans to executive officers.

What are the additional restrictions on loans to executive officers?

Banks cannot lend over $100,000 to an executive officer. (If the higher of 2.5 percent of the bank's unimpaired capital and surplus or $25,000 is lower than $100,000, the lower figure becomes the ceiling.) Executive officers may, however, borrow any amount for loans to finance the education of their children

and for loans to purchase, construct, maintain or improve their residences.

The general individual lending limit of Regulation O operates as the maximum that may be lent to executive officers and their related interests for any purpose, including loans for residential and educational purposes. In addition, loans to executive officers must be reported to the bank's board of directors and be subject to special conditions.

What are the special conditions for loans to executive officers?

Extensions of credit to executive officers must, at the option of the bank, become due and payable if the officer becomes indebted to any other bank(s) in an aggregate amount greater than allowed for a particular category of credit in section 215.5(c). This condition must now be in writing.

Do the additional restrictions on loans to executive officers apply to state non-member banks?

Yes. The provisions relating to executive officers were extended to restrict loans made by a non-member bank to its executive officers. The FDIC adopted the same limit contained in Regulation O to avoid creating any disparity of treatment among banks based on their membership, or lack of membership, in the Federal Reserve System.

Updates for HMDA Reporters

MSA Designation Changes Delayed

When reporting Home Mortgage Disclosure Act (HMDA) data gathered in 1992, lenders should continue to use the metropolitan statistical area (MSA) designations that were in place for most of 1992, not the new ones issued by the Office of Management and Budget.

According to the Federal Reserve Board of Governors, lenders need additional time to convert to the new MSA designations. Therefore, the new designations will become effective for data gathered in 1994.

Additionally, lenders who were previously exempt from HMDA reporting, but who are now covered because of the new MSA designations, will be required to begin collecting HMDA data beginning January 1, 1994.

Timing for Availability Amended

Beginning March 31, 1993, lenders need to make their Loan Application Register (LAR) data available to the public within 30 days of receiving a request.

For privacy, lenders must modify the LAR before releasing it to the public by removing the application or loan number, the date the application was received, and the date of action taken.

Additionally, disclosure statements received from the Federal Financial Institutions Examination Council (FFIEC) must be made available to the public within three business days of receipt.

Digitized for FRASER
https://fraser.stlouisfed.org
Federal Reserve Bank of St. Louis

Fees Must Reflect Services

Several Eighth District bank holding companies charge fees to their subsidiary banks for management services and other services. These services include data processing, marketing, investment advice, legal counsel, loan review and auditing.

This practice is acceptable as long as the fee charged is commensurate with the service provided. Fees cannot, however, be assessed as an alternative to paying dividends. Using such fees to meet debt obligations or to cover general operational expenses is not permissible under the Board of Governors' management fees policy.

Recent bank holding company inspection reports reveal common exceptions to the Board's policy. To ensure that management and service fee assessments comply with the policy and do not constitute inappropriate diversions of bank income, the following guidelines should be used.

Identification of services

When a fee is charged by a holding company for a management service, a corresponding tangible value must be received by each subsidiary bank. This, however, makes it difficult to justify the receipt of management fees by a shell bank holding company. Unless the shell company is providing a specific and valuable service that benefits the bank directly, a management fee arrangement will normally be inappropriate. Operational costs of the parent should be funded with bank dividends.

Pricing of services

In situations where management fees are justified, charges should be based on the fair market value of the specific services. It is appropriate, however, for the company to cover its cost of providing the service plus a reasonable profit — no more than 10 percent of cost — if no market has been established for a particular service.

Documentation

Lack of adequate documentation has often been a problem noted during inspections. Each service to be provided by a holding company to its banks should be documented with a detailed description of the service and the price structure, including a comparative cost analysis.

Timing of service fees

Management fees should be paid in a reasonable and timely manner. Prepayment for services to be provided in the distant future is inappropriate because it unnecessarily diverts income from the subsidiary bank and can be viewed as a violation of Section 23A of the Federal Reserve Act (Section 18j of the Federal Deposit Insurance Act).

Allocation of fees among subsidiary banks

In a multibank holding company, management fees allocated to each bank should be based on the level of services provided to that bank. Charges should be determined by the time and resources expended by the parent in providing the particular service. In most cases, an allocation based simply on a bank's asset size is inappropriate. Asset size could, however, be a reasonable criteria for allocating the parent's advertising expense among its banks.

Written Fee Agreement

All management fee arrangements should be formalized by a written agreement signed by the directors of both the holding company and the banks. This document should identify specific services, associated costs and the billing cycle. It should also specify a review or renewal date.

Any specific questions regarding the management fees policy should be directed to either Dennis W. Blase at 314-444-8435 or Timothy A. Bosch at 314-444-8440.

Digitized for FRASER
https://fraser.stlouisfed.org
Federal Reserve Bank of St. Louis

BANK PERFORMANCE

Exploring Coverage of Nonperforming Loans

Composition Remains Unchanged

While District nonperforming loans have declined during the past six quarters, the composition of these loans remains fairly static.

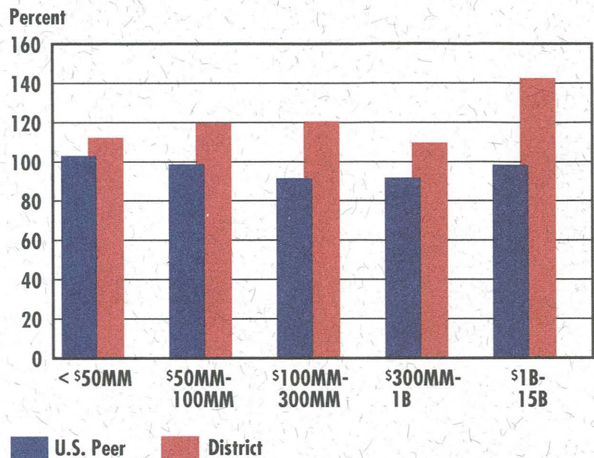
At September 30, 1992:

Real estate	=	55%
Commercial	=	31%
Consumer	=	8%

As of September 30, 1992, coverage of nonperforming loans had increased to a historically high level. District banks have managed to attain and then exceed 100 percent coverage of nonperforming loans. Significantly, this occurred without disturbing the earnings stream. In fact, District bank earnings improved during each of the past three quarters. U.S. peer banks with total assets less than $15 billion by contrast have coverage ratios below 100 percent.

Loan Loss Reserves/Nonperforming Loans

District/U.S. Comparison

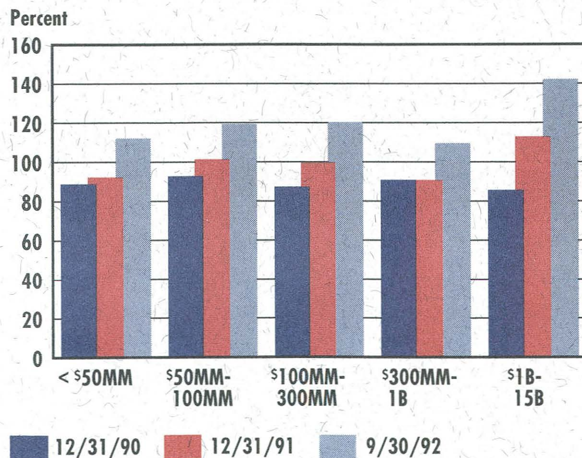


While the coverage ratio varies among the five District bank peer groups noted on the chart below, each peer group demonstrates an increase in its ratio and now exceeds 100 percent. By comparison, only the smallest national peer group reports coverage in excess of 100 percent as seen in the chart above. The coverage ratio measures loan loss reserves as a percentage of nonperforming loans (loans 90 days or more past due and loans placed on nonaccrual).

The increase in District bank reserves results from slightly lower loan losses combined with stable provision expense. More important, nonperforming loans have declined from a high of 1.9 percent of total loans in the first quarter of 1991 to 1.4 percent as of September 30, 1992. U.S. peer banks have not experienced the same combination of positive trends.

Loan Loss Reserves/Nonperforming Loans

District Peer Trend

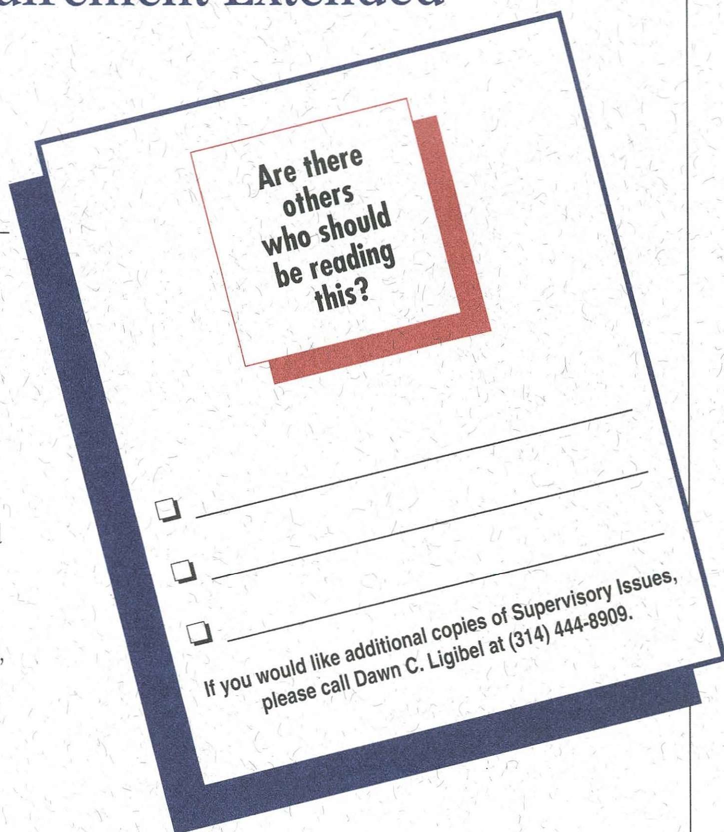


Digitized for FRASER
https://fraser.stlouisfed.org
Federal Reserve Bank of St. Louis

Mortgage Counseling Requirement Extended

The requirement that lenders notify delinquent borrowers of the availability of mortgage counseling within 45 days of an initial loan default has been extended to September 30, 1994.

This extension was part of the Housing and Community Development Act of 1992, which was signed into law on October 28, 1992.



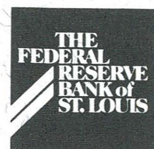
Informational Materials Available

Question and answer booklets on regulations O and DD, which were developed to complement the FDICIA informational meetings recently held throughout the Eighth District, are available to assist in complying with these regulations.

Additionally, a video of the informational meeting held in St. Louis on January 13 is available for $30. In it, Fed speakers provide guidance on the following provisions:

- Prompt Corrective Action applicable to well capitalized banks,
- Regulation O provisions relating to new lending limits,
- Regulation F which provides limitations for interbank liabilities,
- The new real estate lending guidelines, and
- Regulation DD which implements the Truth in Savings Act.

If you would like copies of either booklet or the video, please call Janice Harris at (314) 444-8439.



Post Office Box 442
St. Louis, Missouri 63166

tube 09
CAROL THAXTON
#copies 2

Supervisory Issues is published bi-monthly by the Banking Supervision and Regulation Division of the Federal Reserve Bank of St. Louis. Views expressed are not necessarily official opinions of the Federal Reserve System or the Federal Reserve Bank of St. Louis. Questions regarding this publication should be directed to Dawn C. Ligibel, editor, 314-444-8909.

Digitized for FRASER
https://fraser.stlouisfed.org
Federal Reserve Bank of St. Louis