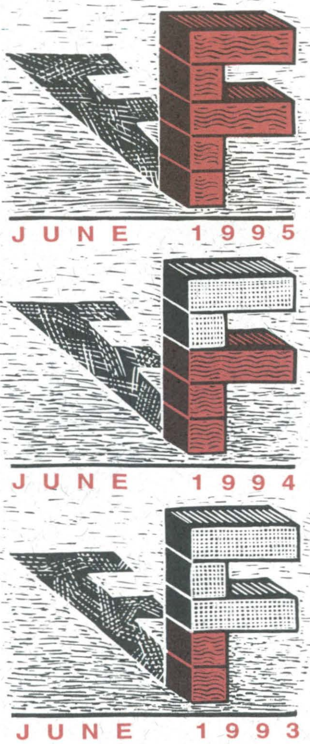
THE FEDERAL RESERVE BANK of ST. LOUIS

# SUPERVISORY ISSUES

May 1993

Supervisory News and Views for the Eighth District




## Revised Reg F Becomes Effective Next Month

In response to comments and suggestions offered by bankers, the Federal Reserve revised Regulation F—Limitations on Interbank Liabilities. The final regulation, which becomes effective June 19, 1993, places primary emphasis on each bank's analysis of the credit quality of its correspondents and reduces the emphasis on regulatory limits to control interbank exposure. Specifically, the final regulation establishes standards for banks to use in selecting and evaluating correspondents, setting internal limits on exposure, and calculating and limiting credit exposure.

### Selecting and Evaluating Correspondents

By June 19, each bank must have written policies and procedures that consider credit, liquidity and operational risks in selecting and using correspondents. These prudential standards may be flexible and should reflect the size, form and maturity of the exposure as well as the financial condition of the correspondent. They should require periodic reviews of the overall financial condition of any correspondent to which the bank has significant exposure.

To evaluate the financial condition of domestic correspondents, a bank may rely on publicly available information such as annual reports, call reports or uniform bank performance reports. In addition, the bank may rely on a third party—such as a parent holding company, a bank rating agency or another correspondent—to provide financial analysis as long as

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## Credit Extensions Allowed Outside LTV Limits

The real estate lending guidelines which became effective on March 19, 1993, include supervisory loan-to-value (LTV) limits. While banks have flexibility in establishing limits in their lending policies, these internal limits may not exceed the supervisory guidelines.

According to the guidelines a bank can make loans that do not meet the supervisory LTV limits. When appropriate, and after consideration of other relevant credit factors, a bank may make an exception or nonconforming loan. This is a loan that exceeds the supervisory limits stated in the guidelines. If a bank chooses to set internal LTV limits lower than the maximum allowed, and a loan exceeds the internal limit, the loan does not have to be considered an exception unless it also exceeds the supervisory limit.

The aggregate amount of exception loans is limited. Depending on the type of loan, it will fall into one of

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## Reg F

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the bank's board of directors approves the assessment criteria used. Once these standards are established, the bank's board of directors must review the policies and procedures at least annually.

### Setting Internal Limits on Exposure

Regulation F does not establish a general limit for exposure to each correspondent. A bank's policies and procedures, however, must provide internal limits in cases where the financial condition of the correspondent and the form or maturity of the exposure create a significant risk that payments will not be made in full or on time. These internal limits should be consistent with the risk undertaken but may be flexible and reflect the credit exposure or financial condition of the correspondent. In addition, different limits may be set for different forms of exposure, different products and different maturities.

### Calculating and Limiting Credit Exposure

While interbank risk includes credit, liquidity and operational risks related to intraday and interday transactions, the regulation defines "credit exposure" as the bank's assets and off-balance sheet items that are subject to capital requirements under federal capital adequacy guidelines and that reflect claims on the correspondent or capital instruments issued by the correspondent.

In calculating credit exposure to correspondents, banks may exclude:

- exposure related to the settlement of transactions, intraday exposure, transactions in an agency or similar capacity where losses will be passed back to the principal or other party, or other sources of exposure that are not covered by the capital adequacy guidelines;
- transactions secured by government securities, the proceeds of checks or cash items not yet available for withdrawal and certain quality assets on which the correspondent is secondarily liable, such as loans purchased with recourse or secured by stand-by letters of credit; and
- exposure covered by federal deposit insurance.

**Internal limits should be consistent with the risk undertaken.**

Banks are not required to limit credit risk to banks that they can demonstrate are at least adequately capitalized. When a correspondent is not adequately capitalized, however, the bank must conform the credit risk of that correspondent to the appropriate regulatory limit within 120 days. Effective June 19, 1994, that limit is 50 percent of capital; in June 1995, that limit falls to 25 percent.

If you have questions about establishing a program to comply with Regulation F, call Timothy A. Bosch at (314) 444-8440 or Dennis W. Blase at (314) 444-8435.

## LTV Limits

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two groups or "baskets." The first basket includes all loans for non–one-to-four-family residential properties; these loans may not exceed 30 percent of the bank's total capital structure. The second basket, which includes all loans for one-to-four-family residential properties, can equal up to 100 percent of the bank's capital structure depending on the percentage in the first basket.

The amount of exception loans in the first basket directly affects the allowable percentage in the second basket. For example, a bank with 30 percent in basket one could only have 70 percent of capital in basket two; a bank with 20 percent of capital in the first basket could have up to 80 percent of capital in the second basket.

**The amount of exception loans in the first basket directly affects the allowable percentage in the second basket.**

Banks will be expected to document all exception loans and report the aggregate amount at least quarterly to their boards of directors. Additionally, banks must report each individual exception loan of a significant size to their boards.

The application of LTV ratios in situations where mixed collateral secures one loan warrants clarification. When several parcels of real estate with different LTV ratios are taken as collateral to secure a loan, the maximum loan amount is determined by applying the appropriate LTV ratio to the collateral value of each parcel of property and adding the resulting values. Any prior liens are deducted from the aggregate value. This sum will be the maximum amount a bank can lend without the credit becoming an exception.

In addition to allowing for exception or nonconforming loans, the guidelines also exempt some loans entirely from the LTV limits. Examples include loans that are government-guaranteed, promptly sold in the secondary market and made prior to March 19, 1993. Loans made prior to March 19 will remain exempt even if they are renewed, refinanced or restructured, as long as no additional funds are advanced.

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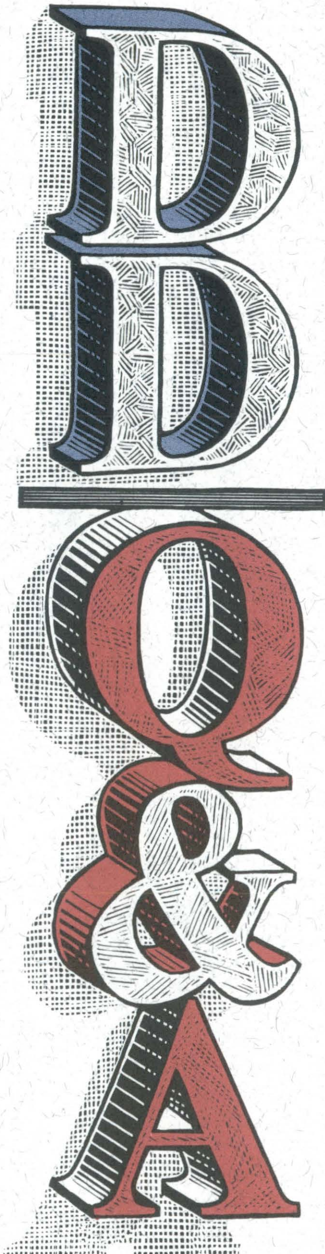
# Examiners Answer Additional Reg DD Questions




As the June 21 compliance date nears, Fed examiners continue to receive questions about Regulation DD. Here are some answers to the most commonly asked questions.

**Must a bank's software system calculate interest on a 365-day basis on all accounts as of June 21, 1993?**

Yes. The interest payment provisions apply to existing consumer accounts as well as new accounts. For time accounts opened before June 21, however, banks can keep current interest calculations for the remaining term of the account. If an account is renewed on or after that date, all aspects of the regulation will then apply.

**May a bank apply the 20-day advance notice as a grace period on automatically renewable time accounts longer than 30 days, and mail the advance notice disclosures and the interest check the day before maturity?**

No. While the Regulation DD alternate timing rule provides flexibility in sending required disclosures closer to the maturity date, Regulation D—Reserve Requirements of Depository Institutions—prohibits a grace period longer than 10 days for withdrawal of funds without penalty on automatically renewable certificates of deposit. This restricts a bank from mailing the interest check and advance notice disclosures on the day before maturity.

**In order to calculate an APY using the formula in Appendix A, a bank must first have a dollar amount for interest paid on a deposit account. How can this dollar amount be calculated?**

Formulas for computing interest can be found in the Fed's "Board Interpretation to Regulation Q (2-412 Computation of Interest—Compounding)." Although these formulas were provided when Reg Q required limits on interest rates paid on deposits, they also have relevance in computing interest on deposit accounts for Reg DD purposes. If you would like a copy of this interpretation, call Janice Harris at (314) 444-8439.

**If a bank passes on to the customer a charge imposed by a third party bank or network for the use of a nonproprietary ATM, and there are no other charges associated with the account, may the bank advertise the deposit account as "free"?**

No. If the bank charges a maintenance or activity fee on the account, the account cannot be advertised as "free." A fee assessed for the use of a third party ATM would constitute a maintenance or activity fee. This is true if the bank marks up the fee, passes on the exact fee or absorbs part of the fee.

**To comply with the periodic statement fee disclosure requirements, must a bank itemize fees separately (for example, "certified check $250, certified check fee $5") or is a single item on a statement permissible (for example, "certified check $255")?**

The periodic statement must disclose the amount of any fees or charges imposed on the account. Additionally, the statement must provide sufficient detail to enable the consumer to identify fees. Therefore, fees for certifying checks must be disclosed separately (for example, "certified check $250, certified check fee $5").

**Must a bank provide new account and other disclosures for accounts that are no longer offered?**

Generally no. New account disclosures are not required for accounts that are no longer offered, even if the bank maintains existing accounts and accounts acquired through merger or acquisition. A bank must,

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however, provide the necessary periodic statements and change-in-term notices for all existing accounts.

**Must a bank provide new account disclosures to existing account holders?**

Generally yes. Account holders who receive periodic statements on or after June 21, 1993, must be given either a notice of the availability of disclosures or the actual disclosures. One or the other must be included on or with the first periodic statement sent on or after June 21, 1993, or the periodic statement for the first cycle beginning after that date. The disclosures are the same as those provided before opening a new account.

**May a bank pay interest on a collected balance?**

Yes. A bank may pay interest on a collected balance as long as credit is given within the deadlines required by the Expedited Funds Availability Act and Regulation CC. The regulation does, however, prohibit the payment of interest based upon a "reservable" or "investable" balance.

# Applications Issues: Exemptions Possible from Stock Redemption Notices

As part of an ongoing effort to limit information needed for bank holding company applications, the Federal Reserve Board announced last fall several changes to its applications process.

Two of those changes were discussed in detail in the November issue of *Supervisory Issues*: the introduction of pre-filing notices and proposals for expansion. This issue takes a look at a third change—the elimination of stock redemption notices for well-capitalized bank holding companies.

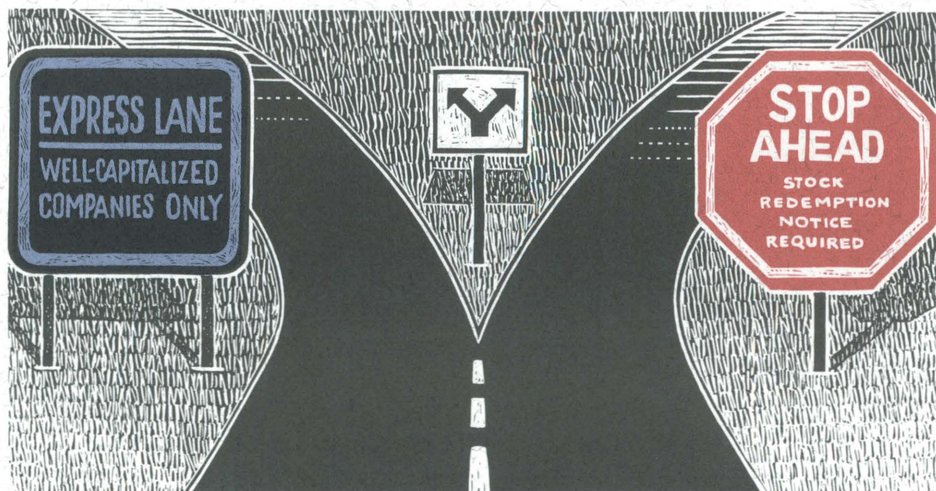
As prescribed in section 225.4(b) of Regulation Y, a company is exempt from the prior notice requirement when redeeming shares representing more than 10 percent of its equity if that company can *demonstrate* that it will remain well-capitalized after these shares are redeemed.

The test for determining whether or not a company is well-capitalized is the same for all companies, *regardless of asset size*, and is based on consolidated capital ratios. The minimum ratios reflect the Prompt Corrective Action provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Specifically, a company is considered well-capitalized if, after the redemption, it has a consolidated leverage ratio of at least 5 percent, and consolidated tier 1 and total capital to risk-weighted assets ratios of at least 6 percent and 10 percent, respectively.

Also, to qualify for the exemption, a company must have received a composite BOPEC rating of 1 or 2 at its most recent inspection, and have no major supervisory matters pending.

A bank holding company that does redeem equity securities should keep appropriate documentation showing that when the stock was redeemed the company was qualified for the exemption. Documentation should include a pro forma consolidated balance sheet for the company and calculations of pro forma consolidated risk-based capital ratios. This information should be available for examiners to review during an inspection.

If you have any questions regarding the eligibility requirements for this exemption, call Carl Anderson at (314) 444-8481.

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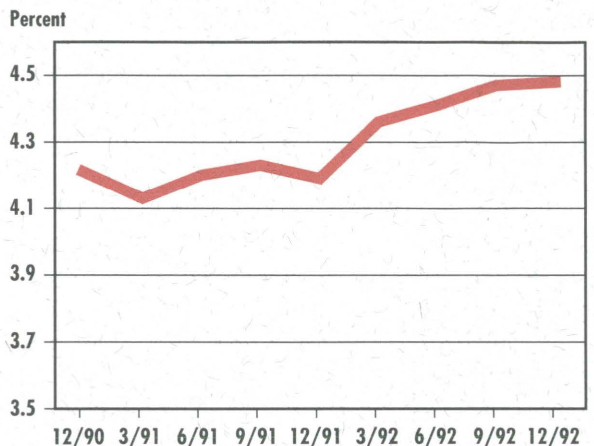
# Bank Performance

## District Banks Outperform National Peers

District bank performance displayed positive trends in 1992 in categories such as higher earnings, improved asset quality and appreciable equity growth. The year was marked by record profits and the highest Return on Average Assets (ROA) posted in recent years. Net income for District banks totaled $1.66 billion, producing an ROA of 1.14 percent.

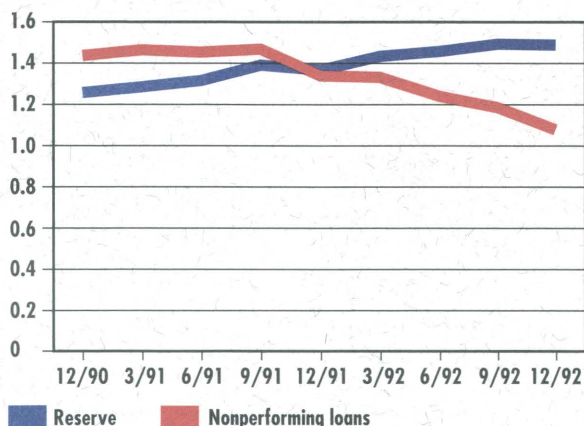
Earnings were boosted primarily through higher net interest income. The net interest margin increased each quarter during the year, hitting 4.48 percent at year-end. In addition to the strong core earnings, slightly lower loan loss provision expense and sizable gains on the sale of investment securities provided an additional boost to net profits.




Perhaps the most noticeable area of improvement was in asset quality. Nonperforming loans declined to the lowest level in years, as did loan losses. The declining level of nonperforming loans combined with provision expenses in excess of loan losses, led to the buildup of reserves to 138.7 percent of nonperforming loans as of year-end 1992. District asset quality indicators compared very favorably with the U.S. peer group averages. Ratios for both nonperforming loans and net loan losses were approximately 40 percent lower than the national average.

As a result of strong earnings performance, District banks achieved significant growth in equity. Cumulative equity growth was 9.9 percent for 1992, compared with asset growth of 4.7 percent. New equity issues accounted for less than 5 percent of the total equity growth.

With such strong showings, District bankers should have a challenging year ahead as they attempt to build on the success of 1992.

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## BHC Supervision Manual Available to Bankers

The Federal Reserve's Bank Holding Company Supervision Manual, which specifies the objectives and procedures Fed examiners use for bank holding company inspections, was recently updated and reprinted. Many companies have found this to be a useful resource in understanding examiner expectations during inspections.

Copies of the manual are available for $50; there will be an additional charge for updates. Requests for copies should be mailed to: Publications Services, Division of Support Services, Board of Governors of the Federal Reserve System, Washington, D.C. 20551. All requests must be accompanied by a check or money order made payable to the Board of Governors of the Federal Reserve System.

## BHC Reporting Instructions Revised

By now, all bank holding companies in the Eighth District should have received updated instructions for the following reports: FR Y-9C, FR Y-9LP and FR Y-11Q. Please discard all previous updates and use only the new instructions when filing these reports. If you have not yet received copies, please call Jim Mack at (314) 444-8599.

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