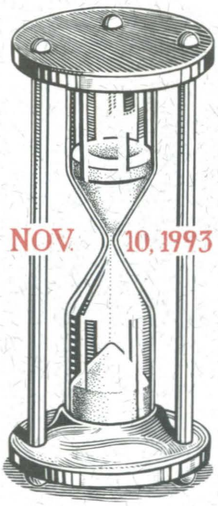
THE FEDERAL RESERVE BANK of ST. LOUIS

SUPERVISORY ISSUES

July 1993

Supervisory News and Views for the Eighth District

Grandfather Clause for Interlocking Directors Expires



Officers and directors of depository institutions should review their status if they are serving under the grandfather clause in Regulation L — "Management Official Interlocks." This clause is scheduled to expire November 10, 1993, at which time all prohibited management interlocks must be severed.

The Depository Institutions Management Interlocks Act, enacted on November 10, 1978, permitted otherwise prohibited management interlocks to continue for ten years if they existed before that date. A 1988 amendment extended this exception an additional five years. That extension ends November 10, 1993.

The Act prohibits executive officers or directors of depository institutions from simultaneously serving as executives or directors of other nonaffiliated depository institutions in the same market or community. It also prohibits interlocking management officials between nonaffiliated organizations, regardless of where they are located, if one organization has total assets over $1 billion and the other has total assets over $500 million. An affiliate organization is one of which 25 percent or more is commonly owned.

ESOPs Receive Increased Attention

An employee stock ownership plan (ESOP) is a tax-qualified employee benefit plan invested primarily in employer stock. ESOPs are designed and administered for the benefit of employee participants. Additionally, they are subject to the Employee Retirement Income and Security Act of 1974 (ERISA) and applicable Department of Labor (DOL) regulations.

As the use of ESOPs has increased among Eighth District banking organizations, more and more bankers have questions concerning the status of ESOPs under the Bank Holding Company Act and the supervisory treatment of transactions between ESOPs and bank holding companies.

Status of ESOPs Under the Bank Holding Company Act

An ESOP is a *company* for purposes of the Bank Holding Company Act. Therefore transactions by which an ESOP will acquire 25 percent or more of any class of voting securities of a bank or holding company are subject to prior approval from the Federal Reserve System.

In addition, an ESOP is considered a *person* under the Change in Bank Control Act. Therefore an ESOP acquiring 10 percent or more of any class of voting securities of a bank or bank holding company must file a Change in Bank Control notice *if* no other person owns

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ESOPs
(continued from front page)

a greater percentage of that class of voting securities *or* if the company is registered with the SEC.

Application Considerations

An ESOP filing an application for prior approval under Section 3 of the Bank Holding Company Act or a notice under the Change in Bank Control Act will be asked to respond to inquiries designed to determine compliance with DOL regulations. For instance, the Reserve Bank will request a copy of the plan and trust agreements governing the ESOP and the IRS determination letter verifying the plan's tax exempt status under Section 401 of the Internal Revenue Code. In addition, if a pension or profit sharing plan was terminated to establish the ESOP, the applicant will be asked to provide evidence of the Pension Benefit Guaranty Corporation's approval of plan termination.

Financial Effect of ESOP Transactions

ESOP debt is generally serviced with tax deductible contributions by a sponsoring employer. As such, the ESOP's sponsoring employer may guarantee the ESOP's debt or commit to make sufficient future contributions to ensure the ESOP's ability to repay its debt. The Federal Reserve System generally permits bank holding companies to guarantee the debt of an affiliated ESOP consistent with safe and sound banking practices.

If debt incurred to acquire employer securities is accompanied by an underlying guarantee or commitment by the employer bank holding company, the Generally Accepted Accounting Principles (GAAP) require adjustments to a bank holding company's balance sheet. Because this guarantee or commitment is, in substance, a liability of the employer bank holding company, the company must record a liability account for the amount of the ESOP debt and offset that entry by reducing shareholders' equity.

The Federal Reserve generally permits bank holding companies to guarantee the debt of an affiliated ESOP.

As the ESOP makes payments on its debt, the liability recorded by the employer bank holding company is reduced accordingly. The resulting additional debt burden and corresponding reduction in shareholders' equity produced by this accounting treatment will be analyzed by the Federal Reserve System to ensure compliance with regulations and standards regarding parent company debt and capital adequacy.

When an ESOP incurs debt to fund the acquisition of employer stock with no guarantee or commitment from the employer bank holding company, the ESOP is treated like any other shareholder and no adjusting entries are made to the employer bank holding company's balance sheet. Likewise, when an ESOP acquires employer bank holding company stock without debt, the ESOP is treated like any other shareholder and no adjusting entries are made to the employer bank holding company's balance sheet.

Supervisory Concerns

ESOPs generally avoid borrowing from affiliated banks or having their affiliated banks guarantee their debt to escape the restrictions of Section 23A of the Federal Reserve Act. Section 23A states that the securities issued by an affiliate of the bank shall not be acceptable as collateral for a guarantee issued on behalf of that or any other affiliate.

Because ESOPs invest primarily in employer company securities, they generally will not have sufficient other assets to pledge as collateral to satisfy the requirements of Section 23A. Accordingly, ESOP debt is generally obtained from unaffiliated lenders to avoid these restrictions and potential violations.

ESOPs should be designed and administered for the benefit of the participants.

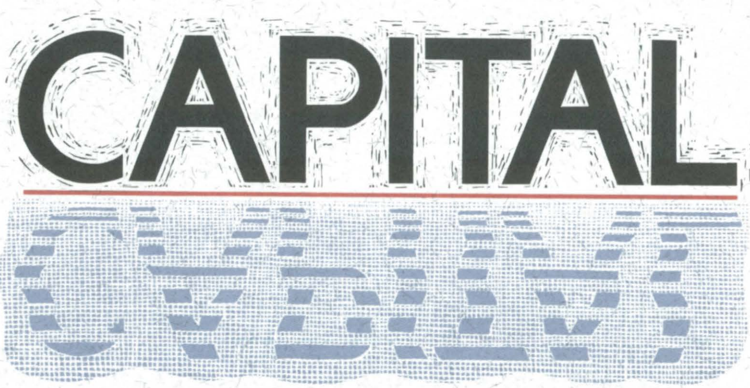
ESOPs receive tax benefits that may result in banking organizations viewing ESOP purchases as an important contributor to capital growth. For example, employer contributions to ESOPs that are applied to the repayment of ESOP debt generally qualify as tax-deductible for the employer, and dividends paid on shares of employer stock owned by an ESOP may qualify as a tax-deductible expense for the employer. Transactions between an employer company and the ESOP, however, must always be in the best interest of the participants. For that reason, it is inappropriate for an employer company to view an ESOP as a market maker for its own stock or as a funding vehicle for the holding company.

Thus Eighth District banks considering establishing an ESOP should remember that ERISA and DOL regulations require that an ESOP be designed and administered for the primary benefit of its participants. It is also important to remember that depending on the ESOP's percentage of ownership of employer bank or bank holding company stock, the ESOP may be subject to federal banking rules and regulations.

Reflect Your Capital Position Correctly

Capital is receiving additional emphasis as a measure of institutional condition. With this increased focus, it is more important for institutions to ensure that the reports on which they record capital are complete and accurate.

An analysis of the Call Report and the FR Y-9C shows that risk-based capital schedules are often completed incorrectly. Many reporters appear to be using the same set of instructions for both reports, when in fact, the capital schedules in the FR Y-9C differ from capital schedules in the Call Report.



The following gives specific guidance for avoiding the most common errors.

Call Report

When completing the *Risk-Based Capital* section (Schedule RC-R) of the Call Report, be sure to review the definition and components of *adjusted total assets* and *total qualifying capital* allowable under the risk-based capital guidelines. Keep the following in mind:

- Goodwill and other disallowed intangible assets should be subtracted when computing tier 1 capital.
- As of December 31, 1992, the amount of allowance for loan losses qualifying for tier 2 capital was limited to 1.25 percent of risk-weighted assets.

For banks with total assets less than $1 billion, the preceding list will ensure accurate completion of Schedule RC-R.

FR Y-9C

On the FR Y-9C, completing *Additional Details on Capital Components* (Schedule HC-IC) and the Memoranda items on *Risked-Based Capital* (Schedule HC-I) accurately is critical to computing tier 1 capital and total capital for bank holding companies. These schedules determine the risk category to which the particular capital component belongs and the value ultimately assigned to that component.

Call Report and FR Y-9C

Confusing the difference between the credit conversion factor (CCF) and the risk-weighting factor (RWF), both of which are used in computing risk-weighted assets, is a common error made on both the Call Report and the FR Y-9C.

- The CCF converts an *off-balance sheet* item to a credit equivalent amount, which is then treated as an on-balance sheet asset. (Be sure to show the credit equivalent amounts of off-balance sheet items in the appropriate fields for both Call Report and FR Y-9C schedules.) Failing to report the credit equivalent amounts has frequently resulted in an overstatement of risk-weighted assets on the FR Y-9C.
- The RWF converts all *on-balance sheet* assets to risk-weighted assets.

Before submitting either report, ensure that all data are accurate. Be sure line items correspond with supporting schedules and memoranda items. Once these reports are completed accurately, keep a full set of workpapers for examiners to review.

If you have questions about risk-based capital schedules or any other regulatory reports, call Jim Mack in the Statistics Section at 314-444-8599 or Rita Rauba in the Banking Supervision and Regulation Division at 314-444-8850.

Take a Closer Look at Consumer Lending

While new consumer laws are being implemented, bankers may want to review existing disclosures to avoid potential problems. The following takes a look at three specific issues with consumer lending.

Required Deposit Balance

Now that interest rates have declined substantially, banks may be required to make an additional disclosure to credit customers as stated in Section 226.18(r) of Regulation Z. If a creditor must maintain a deposit as a condition in a loan agreement and the deposit earns less than 5 percent, the customer must be informed that the quoted annual percentage rate does not reflect the effect of the required deposit.

This notice can be accomplished by simply adding a standard clause to the disclosure statement. The model clause in Appendix H reads, "The annual percentage rate does not take into account your required deposit."

Security Interests

Computerized loan processing systems and preprinted disclosure forms are causing compliance problems with Section 226.18(m) of Regulation Z, which requires a creditor to disclose whether a security interest in the property will be acquired. Unfortunately, many form vendors and in-house computer programs are automatically marking boxes on disclosure forms to indicate security interests. In some cases, such disclosures can violate Regulation Z.

Such a violation can occur if a creditor attempts to disclose a right of set-off by checking the box indicating a security interest in "my deposit account and other rights I may have to the payment of money from you." Because a bank's right of set-off arises by operation of law, it should not be included with the disclosures required under Section 226.18(m). The bank may, however, state this right elsewhere in the contract and invoke and enforce the right in accordance with state law.

As this example shows, bank personnel should consider each specific situation when determining appropriate disclosures required by Regulation Z.

Rule of 78s

Assessing compliance with the provisions of Section 933 of the Housing and Community Development Act of 1992 will become part of ongoing consumer compliance examinations for state member banks.

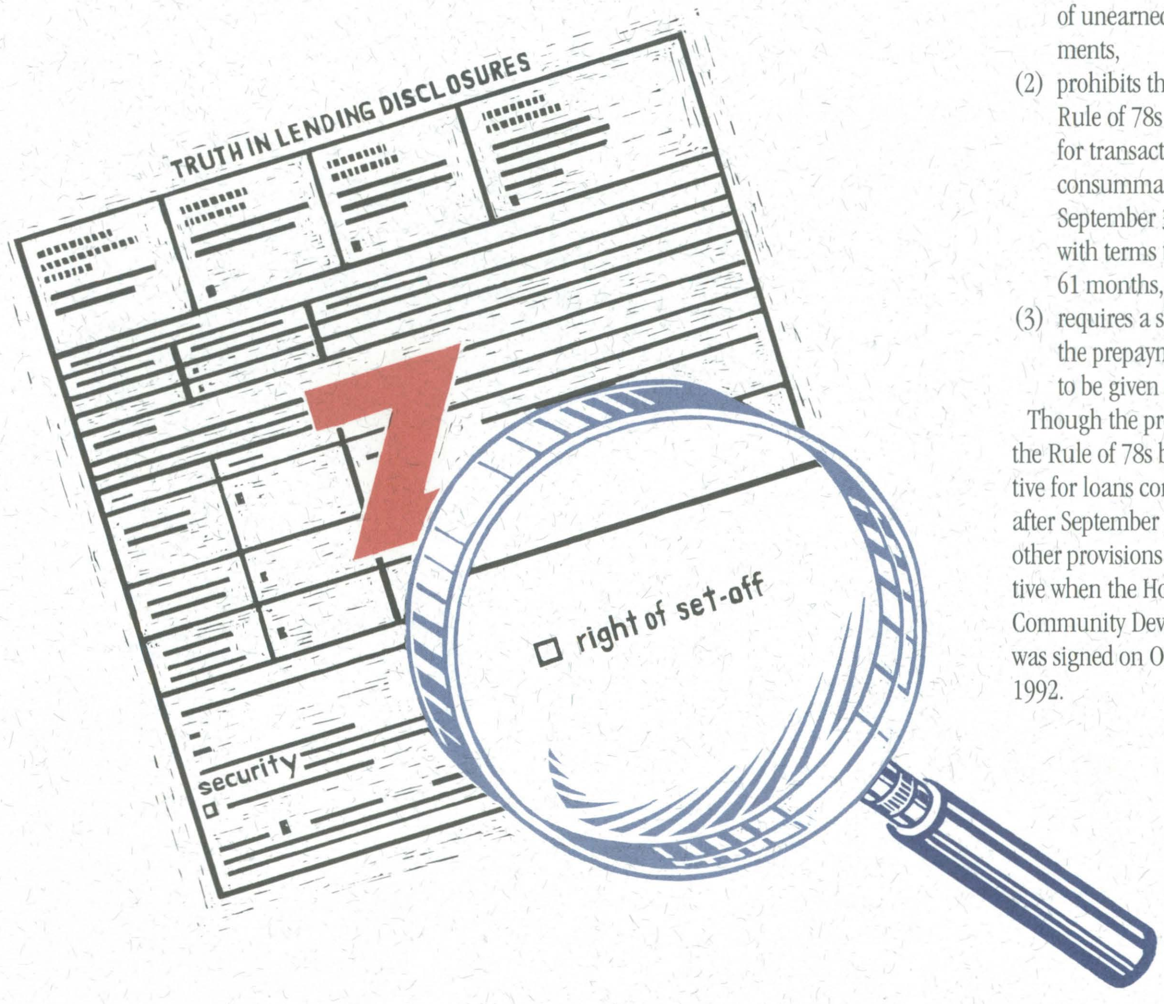
Specifically, Section 933

(1) requires prompt refunds of unearned interest payments,

(2) prohibits the use of the Rule of 78s rebate method for transactions that are consummated after September 30, 1993, and with terms that exceed 61 months, and

(3) requires a statement of the prepayment amount to be given on request.

Though the prohibition of the Rule of 78s becomes effective for loans consummated after September 30, 1993, the other provisions became effective when the Housing and Community Development Act was signed on October 28, 1992.



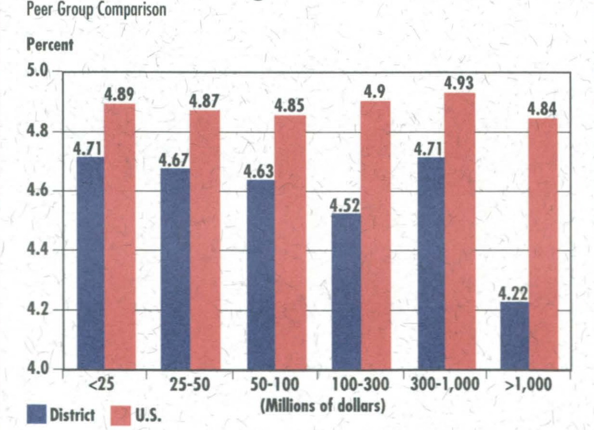
Bank Performance

Examining Eighth District Net Interest Margin

For some time, we have reported that District banks' return on average assets (ROA) has been above their national peers, while at the same time their net interest earnings have been lower. Reviewing year-end District data by peer group size and state illustrates two interesting points. While all asset size groups and six of the seven District states have average net interest margins below national peers, this difference is most pronounced in large banks and in Kentucky and Missouri.

The District's 16 largest banks, all with assets over $1 billion, trail the national peer interest margin significantly by 62 basis points. These banks hold 35 percent of District banking assets and thus have considerable influence on the District margin.[1]

Net Interest Margin
Peer Group Comparison



Comparative Margin Analysis
Eighth District States
Ranked by Descending Interest Margin

State	NIM*	Interest Income	Interest Expense
Mississippi	5.08%	8.69%	3.61%
Tennessee	4.62%	8.11%	3.49%
Illinois	4.61%	8.64%	4.03%
Arkansas	4.61%	8.05%	3.44%
Indiana	4.57%	8.70%	4.13%
Kentucky	4.28%	8.09%	3.81%
Missouri	4.27%	7.84%	3.57%

* Net Interest Margin

Additionally, more than 60 percent of these assets are located in the Louisville and St. Louis banking markets. An average of 58 percent of the loans in the portfolios of these banks consist of commercial and industrial loans, and loans secured by commercial real estate — excluding residential mortgages (1-4 family) and home equity loans. The average yield on the commercial and industrial loans is 6.8 percent. While the average real estate loan yield is 8.4 percent, this reflects the influence of the residential mortgages and home equity loans. By comparison, these banks average only 20 percent of their portfolios in consumer, installment, and credit card loans which have yields of 8.5 percent and above.

As the chart to the left shows, both Kentucky and Missouri have the lowest net interest margins due to the combined effects of the large banks' influence and the loan mix and yields previously described. The lower yields coupled with a higher interest expense in these states produce the lower net interest margin.

To assess this effect further, data for the largest banks from the Louisville and St. Louis markets were isolated. With these seven banks removed, the District average net interest margin climbs 12 points to 4.60 percent. Relatively, this accounts for 30 percent of the total difference between the District and U.S. peer. The effect of removing the largest banks is even greater on the state averages. For Kentucky, removing the three largest banks increases the margin by 14 basis points to 4.42 percent. In Missouri, the margin increases 21 basis points to 4.49 percent. These increases would bring both states in line with the District average.

[1] *The District, peer group, and state interest margin averages are calculated on a weighted basis. Thus the relative size of a bank or group of banks has a proportionate effect on the ratio.*

HMDA Time Frames Shortened

Remember that the Housing and Community Development Act of 1992 changed the timing requirements for Home Mortgage Disclosure Act (HMDA) disclosure statements. After financial institutions receive their disclosure statements from the Federal Financial Institutions Examination Council (FFIEC), they must make them available to the public within three days at home offices and within ten days at appropriate branch offices. Institutions will still have 30 days, however, to review the statements for accuracy and content.

Questions about HMDA disclosure statements should be directed to the appropriate federal regulator. Institutions that report data to the Federal Reserve Bank of St. Louis should call Bob Dowling at (314) 444-8532.

Supervisory Issues Enters Second Year

At the one-year anniversary of *Supervisory Issues*, we want to know if we are meeting your expectations with this newsletter.

Please take a few minutes to complete the enclosed survey and drop it in the mail. We appreciate you taking the time to respond.

THE FEDERAL RESERVE BANK of ST. LOUIS

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