THE FEDERAL RESERVE BANK of ST. LOUIS

SUPERVISORY ISSUES

November 1993

Supervisory News and Views for the Eighth District

FASB 115 Affects Investment Strategies

As Eighth District banks implement FASB 115 — the new accounting standard for debt and equity securities — each institution should consider carefully how its investment portfolio is structured. Because the standard limits a bank's flexibility in managing its portfolio, each institution should carefully evaluate its intent when investing in a debt or equity instrument. Bank management must assure that the portfolio, as a whole, meets policy objectives for managing liquidity and interest rate risk.

The new standard, which becomes effective January 1, 1994, establishes three securities classifications that more accurately reflect the intent behind management's investment activities. The new classifications are as follow:

Held to Maturity

Securities designated as "held to maturity" are reported at unamortized cost, and gains and losses are recognized on the income statement only upon the sale of the security. Securities are eligible for this classification only if bankers have the positive intent and ability to hold these securities to maturity.

Securities in this category may be sold or reclassified only if isolated, unusual or non-recurring circumstances arise that could not have been anticipated when the securities

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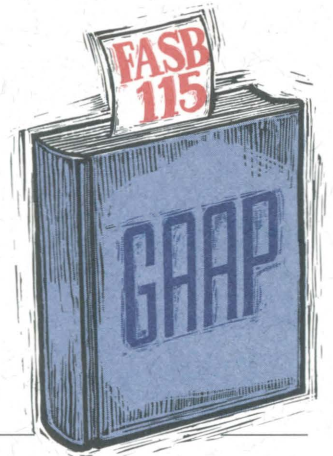

Small BHCs Need Adequate Records

Fed examiners report that field inspections of small bank holding companies continue to reflect inadequate financial record keeping. While retaining an independent accountant and seeking advice is appropriate, responsibility for maintaining a complete record-keeping system and preparing financial statements remains with company management.

What Do Companies Need?

It is important to remember that all BHCs are financial institutions under existing laws and regulations. Fed examiners, therefore, expect the management of each holding company to understand and maintain an adequate on-site financial record-keeping system.

The system must account for both cash and accrual entries, maintain adequate information about the entries, and allow for accurate preparation of financial statements and reports. Dual signature requirements and independent review of entries should be

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FASB 115

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were purchased. Bankers may not use such securities to meet liquidity needs, transfer them to other investment accounts or hedge them against interest rate risk. If securities classified as held to maturity are sold or reclassified, the intent underlying the classifications of the remaining securities may be questioned.

Trading

Securities purchased for the purpose of taking advantage of short-term movements in price are designated as "trading" and reported at fair value. Any changes in fair value, regardless of whether the securities are sold, are recognized as realized gains and losses on the income statement. There are no restrictions on selling trading securities.

Available for Sale

Securities classified as "available for sale" are reported at fair value, with changes in fair value recognized (net of tax) as unrealized gains and losses in a new equity account. Upon sale, gains and losses are recognized through income. Available-for-sale securities may not be held for short-term sale.

Call report instructions will be changed to reflect FASB 115 beginning with the quarter ending March 31, 1994.

The federal banking agencies will request comments on whether the new equity account — which captures changes in the fair value of available-for-sale securities — should be included in measures of capital adequacy.

Bankers reviewing the structure of their investment portfolios may wish to consult an independent accountant for further information on how the new standard will affect investment decisions.

Record Keeping

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implemented as an internal control procedure.

A complete set of records includes a cash receipts/disbursements journal, general ledger and general journal. Records must show that transactions are promptly recorded, clearly detailed and supported by original receipts or workpapers. Financial statements must be prepared according to generally accepted accounting principles (GAAP) and reconciled with regulatory reports.

What Are the Benefits of a Good System?

A good financial record-keeping system will result in the following benefits:

- Management will have accurate financial information with which to make informed decisions.
- Outside accounting and auditing costs will decline since billings are directly proportional to the time spent reconciling the records and preparing the financial statements.
- Examiners will be able to complete on-site inspections more quickly.
- Ongoing Fed monitoring of the company's financial condition will be more effective.

Financial statements must be prepared according to GAAP and reconciled with regulatory reports.

What Are Examiners Finding?

The following record keeping exceptions are commonly noted in inspection reports:

- A checkbook is maintained as the only record for cash entries and a sufficient written explanation is not provided for each entry.
- Accrual entries are recorded as of the financial reporting date without adequate documentation or understanding of the basis of the entry.
- Entries are not in compliance with GAAP.
- Transactions are either recorded late or omitted.
- Important financial documents and related records are maintained off-site in an accountant's office.

These exceptions indicate that company management has inadequate knowledge and control of the records; therefore, management may not be able to fulfill its corporate and fiduciary responsibilities to manage the company's financial affairs. In addition, such record keeping inevitably results in errors in the FR Y-6 *Annual Report for Bank Holding Companies* and FR Y-9 *Financial Statements for Bank Holding Companies*.

What Can Management Expect?

During each on-site inspection, examiners will ask management to research and correct any record keeping exceptions. Deficiencies in the system will be cited in the Report of Bank Holding Company Inspection. In addition, if examiners determine that regulatory reports are materially misstated, management must amend and resubmit the reports.

The Fed's staff closely checks all regulatory reports, and repeated errors that result from an inadequate financial record-keeping system may lead to supervisory action.

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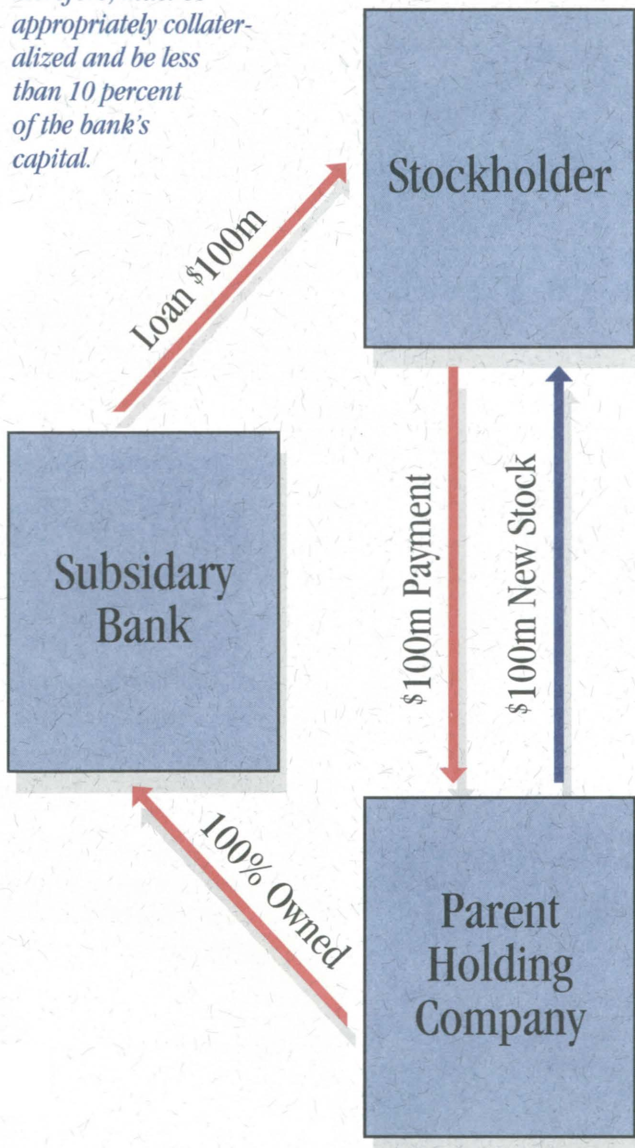
Section 23A: Questions and Answers

Examination and inspection reports frequently reflect violations of Section 23A of the Federal Reserve Act. Section 23A is designed to prevent the misuse of a bank's resources resulting from credit extensions and asset purchases between a bank and its affiliates. These "covered transactions" are limited in amount and may be subject to specific collateral requirements.

The loan from the subsidiary bank to the stockholder is a covered transaction because the parent holding company received the loan proceeds. The loan, therefore, must be appropriately collateralized and be less than 10 percent of the bank's capital.



Following are questions and answers addressing common violations of Section 23A.

Are transactions between a bank and its parent holding company covered by Section 23A?

Yes. Because the parent company is an affiliate of the bank, extensions of credit to the parent are limited to 10 percent of bank capital and must be properly secured. For example, an overdraft in the parent company's demand account held at its subsidiary bank is a violation of Section 23A if it is not adequately secured by qualifying collateral.

Are expenses that a bank prepays to its parent company considered extensions of credit?

Only when the prepayment significantly precedes the bank's receipt of the service for which payment is being made. Examiners closely review the amount and timing of management fee and tax benefit payments to ensure the bank is not disadvantaged by its affiliation with the parent holding company.

Is an Employee Stock Ownership Plan (ESOP) that owns stock in its parent holding company an affiliate of a bank within the same holding company?

Yes. The term "affiliate" includes any company either sponsored or advised by the bank, or any subsidiary or affiliate of the bank. Both amount and collateral limitations apply to transactions between a bank and the ESOP.

Are all transactions between "sister banks," which are banks and thrifts that are 80 percent or more owned by the same company, exempt from Section 23A?

No. A bank may not purchase low-quality assets from a sister bank. Low quality assets include examiner-classified assets, past-due and nonperforming loans and other real estate. In addition, transactions between sister banks must be on terms and conditions consistent with safe and sound banking practices.

How is capital defined for the purposes of Section 23A amount limitations?

Capital is the sum of a bank's or thrift's common stock, surplus, retained earnings (collectively reported as equity), plus the unallocated portion of the loan loss reserve.

How is the 10 percent capital limit applied when a bank periodically buys loans from a nonbank affiliate, such as loans originated and initially funded by an affiliated mortgage company?

The dollar value of loans that can be purchased in any transaction would be limited to 10 percent of capital minus

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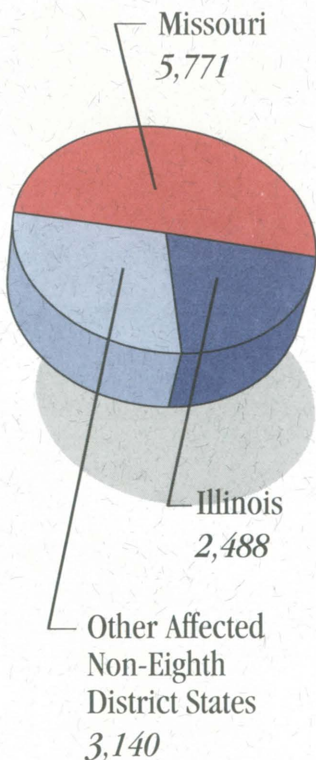
the remaining balance of mortgage loans previously purchased. For example, if 10 percent of bank capital is $10 million and the remaining balance of loans which the bank previously purchased is $6 million, then the bank may buy no more than $4 million of loans in this transaction.

Is a loan for the purpose of purchasing securities of the bank's parent company a "covered transaction" under Section 23A?

Yes. If the proceeds of the loan benefit the parent company by funding payment for newly issued or Treasury shares, then the loan must comply with all provisions of Section 23A in the same manner as if the extension of credit were made directly to the holding company. Furthermore, the parent company's stock does not qualify as acceptable collateral. If, however, the loan proceeds fund the purchase of stock from an unaffiliated third party, then the individual and aggregate quantitative limits apply to the transaction.

Bankers with additional questions about Section 23A are encouraged to review the statute (12 USC 371c) found at Paragraph 3-1110 of the Federal Reserve Regulatory Service. If further assistance is needed, call Timothy A. Bosch, Assistant Vice President — Western Region (Arkansas, Mississippi, and Missouri) at (314)444-8440 or Kim D. Nelson, Assistant Vice President — Eastern Region (Illinois, Indiana, Kentucky, and Tennessee) at (314) 444-8735.

Flood Claims Reflect Limited Protection



Initial insurance claims on losses from the Great Flood of '93 suggest that many lenders may be underinsured. As of October 20, 1993, a total of 11,399 claims had been filed with the National Flood Insurance Program. Two Eighth District states, Missouri and Illinois, filed 8,259 of those claims. In Missouri, the average claim is $30,827; in Illinois it is $22,128.

Historically, compliance with the mandatory purchase of flood insurance guidelines has averaged 20 percent. Early reports from affected regions cause program administrators to estimate, however, that only 10 percent of those required to purchase flood insurance complied with the guidelines. The low claims rate and the past payment experience indicate that bankers should review loan administration programs to ensure that loan review procedures test for adequate flood insurance coverage.

Under the National Flood Insurance Program, bankers who extend credit in special flood hazard areas must require flood insurance as a condition of any new, increased, extended or renewed loan secured by improved real estate or a mobile home.

In special flood hazard areas, which are areas with a 1 percent probability of having a flood that either equals or exceeds the last flood, the insurance must at least be equal to the loan's outstanding principal balance or up to the maximum limit of the available coverage, whichever is less.

If a financial institution fails to require an initial insurance purchase or the borrower fails to maintain adequate insurance, lenders may require the borrower to purchase insurance at any time during the life of the loan. To ensure that the banker is fully protected, the loan agreement should include a provision that allows the banker to obtain insurance and charge either the escrow account or the borrower for the cost.

Additionally, lenders that are regulated by the Fed must require flood insurance on property located in communities that participate in the National Flood Insurance Program, even if the property securing the loan is located outside of a special flood hazard area. For example, additional caution may be warranted in area that undergo flooding as a result of storm water and in remote areas where the Federal Emergency Management Agency (FEMA) has not designated any flood hazard areas. The National Flood Insurance Program offers a low cost "preferred risk" policy to facilitate the purchase of flood insurance outside special flood hazard areas.

Safe lending in flood-prone areas can be achieved when institutions are aware of their rights and obligations. A comprehensive handbook, *Mandatory Purchase of Flood Insurance Guidelines*, can be obtained by calling FEMA at 1-800-638- 6620.

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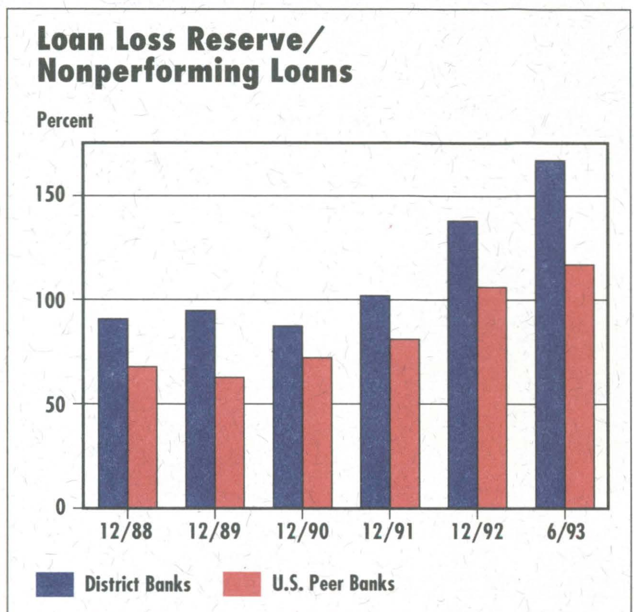
Bank Performance

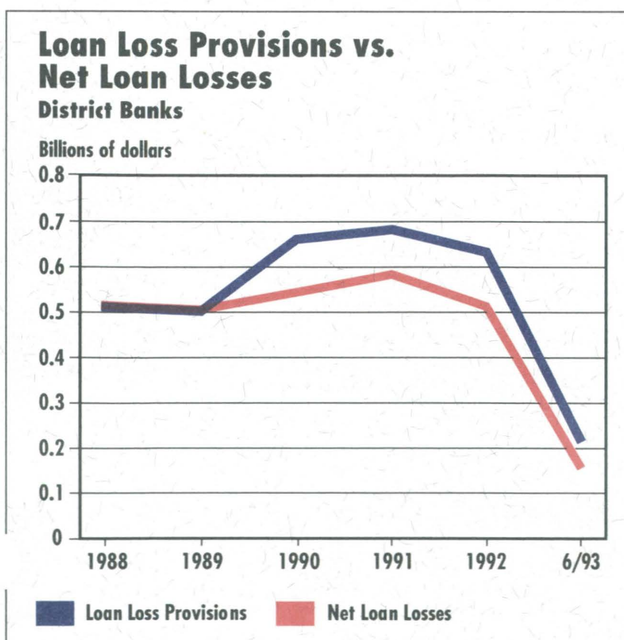
Large Reserves Reflect Industry Improvement

Although industry and supervisory attention has focused on lower short-term interest rates, wider net interest margins, and record earnings, other indicators of improved banking conditions have not gone unnoticed. During the past year and a half, the ratio of loan loss reserves to nonperforming loans has increased to record levels. As of June 30, 1993, the aggregate coverage ratio for District banks reached 167 percent. This ratio is 50 percentage points ahead of U.S. peer banks with total assets less than $15 billion. (See chart at right.)



The increase in this ratio suggests that reserves have exceeded an appropriate level. An analysis of changes in the reserve for both District and U.S. peer banks, however, indicates that declines in provision expense have generally followed declines in nonperforming loans. Since year-end 1990, nonperforming loans have decreased by 34.1 percent among District banks and by 38.6 percent nationally. These sizable decreases are primarily responsible for the increase in the coverage ratio.

Provision expense has declined in tandem with lower loan losses for District banks since year-end 1991, as illustrated in the chart to the left. However 1993 has brought about the most significant decline in recent years with provision expense 26.5 percent lower than the comparable period in 1992. If these significant declines remain constant in the second half of this year, the provision expense for the entire year will be at its lowest point in five years.



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Agencies Warn Against Questionable Instruments

The enforcement staffs of the federal banking agencies have noted an increase in the use of questionable financial instruments — "Prime Bank" notes, guarantees and letters of credit — in complex and potentially illegal schemes aimed at defrauding borrowers, investors and banks.

Since the agencies are unaware of any legitimate use for such documents, institutions should be alert to the possible dangers associated with any "Prime Bank"- type instrument.

Institutions should also be attentive to the attempted use of any traditional type of financial instrument — such as a standby, performance or commercial letter of credit — in a manner that may be unconventional.

In the event that any such transaction becomes apparent, please advise the appropriate federal regulator:

Federal Reserve Board of Governors
(202) 452-2620

National Credit Union Administration
(703) 518-6540

Federal Deposit Insurance Corporation
(202) 898-6750

Office of the Comptroller of the Currency
(202) 874-4800

Office of Thrift Supervision
(202) 906-6853

In keeping with the applicable criminal referral regulations, suspected criminal offenses require a prompt criminal referral to the appropriate law enforcement agencies.

Future notices of fraud activity that may affect District institutions will be communicated over the administrative wire.

MSA Designations

The Office of Management and Budget (OMB) issued new metropolitan statistical area (MSA) designations on June 30, 1993, that replace the designations that the OMB issued on December 28, 1992. The new MSAs, which take effect on January 1, 1994, will be used to determine coverage and collect 1994 HMDA data.

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