SUPERVISORY ISSUES

January 1994

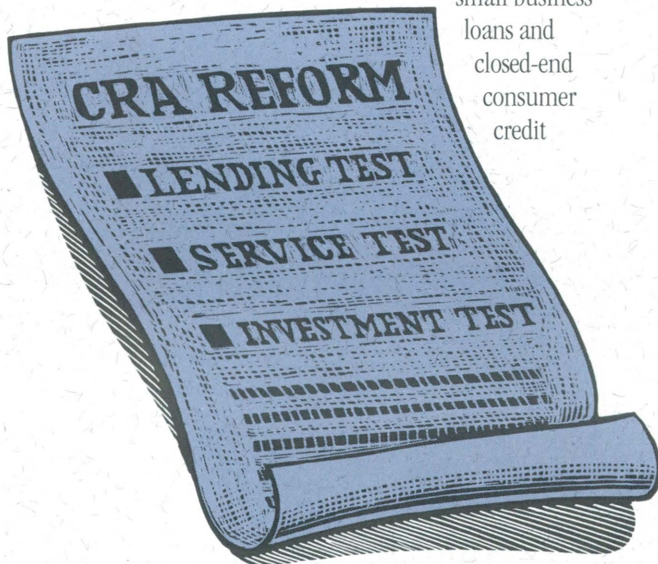
Supervisory News and Views for the Eighth District

Agencies Seek Comment on CRA Reform Proposal

The federal banking supervisors have issued for public comment a proposal, which emphasizes actual lending, service, and investment records benefiting low- and moderate-income communities, to revise the Community Reinvestment Act (CRA). The proposal replaces the 12 assessment factors with three evaluation standards.

The Lending Test

The *lending test* evaluates an institution's lending through closed-end mortgage loans, small business loans and closed-end consumer credit (collectively termed reportable loans) by using two separate measures. The market-share test evaluates a bank's lending by taking into consideration reportable loans made by all lenders subject to CRA. It compares a bank's market share of reportable loans in low- and moderate-income communities in its service area with its market share of such loans in the remainder of its service area. The bank will also be evaluated independently of how others are performing by examining:



- the reportable loans it made in its low- and moderate-income communities as a percentage of its other loans in those communities; and
- reportable loans in low- and moderate-income communities as a percentage of reportable loans in its entire service area.

In determining its performance under this test, an institution may add to its direct lending, indirect lending through investments in loan pools, lending consortia and subsidiaries, and community development or affordable housing lenders.

In measuring an institution's lending performance, the agencies will rely on aggregate lending data reported by all institutions subject to CRA. Computations of market share will include the volume and number of loans for each reportable category.

In its request for comments on the proposal, the agencies ask:

- **Should indirect loans be included in the lending test?**
- **Should the lending test rest on ratios using only loans made by institutions subject to CRA reporting rather than loans made by all lenders in the relevant market?**

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CRA Reform

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The Service and Investment Tests

The *service test* evaluates the accessibility of an institution's branches to low- and moderate-income areas and the provision of services that promote the availability of credit. Banks do not need to expand branch networks or operate facilities at a loss. Special accomplishments or programs that provide greater access to credit, capital or services will, however, receive consideration.

The lending test evaluates an institution's lending by using two separate measures.

Investments qualifying for the *investment test* include affordable housing; small business and other economic development initiatives; community development banks; organizations and initiatives that foster community development; small business, and minority-owned agency housing or revenue bonds.

Under the proposal, a retail institution's CRA rating is based primarily on the lending test. Its performance under the service and investment tests, however, may increase or decrease its composite rating. In seeking comments on the proposal, the agencies ask:

- **Are the lending, service and investment tests meaningful and workable?**
- **Should the quantitative measures be expanded to include measures other than lending, service and investments?**
- **Should the performance of affiliates be considered in CRA examinations of regulated banks or thrifts?**

Small-Institution Assessment Standards

Under the reform proposal, an independent institution with less than $250 million in assets or a bank holding company with less than $250 million in consolidated assets, may choose to be assessed under certain criteria. A small institution is presumed to be satisfactory if it:

- has a reasonable loan-to-deposit ratio (a 60 percent ratio is presumed to be reasonable);
- makes the majority of its loans in its service area;
- has a good loan mix across product lines and income levels of borrowers;
- has no legitimate, complaints from community members; and
- has not engaged in a pattern of illegal discrimination.

The service test evaluates the accessibility of branches and the provision of services.

An institution failing to meet or exceed each test will be subject to additional examiner evaluation reflecting the lending, service and investment tests, including the reasonableness of the distribution of loans reflected in the HMDA data for any banks that are reporters.

"Small" institutions may choose to be assessed under performance criteria.

Data Collecting and Reporting

This performance-based approach requires institutions that do not elect, or are not eligible for the small-institution assessment method, to collect and report additional data on the geographic distribution of small business, mortgage and consumer loans, including written applications, denials, originations and purchases. If a retail institution elects to count indirect loans for its lending test, data will have to include reports on attributable indirect loans, which includes loans made outside low- or moderate-income areas. Data on small business loans will be reported in four categories based on the sales volume of the business. Institutions not now covered by HMDA will have to collect and report certain summary mortgage data but will not have to report home mortgage data in the detail required by HMDA.

In requesting comments on this portion of the proposal, the agencies ask:

- **What are the costs and benefits of the proposed provisions for data collection?**

Because the proposal is far reaching and represents a dramatic change in approach to the CRA, comments from bankers and other members of the public may significantly affect the final proposal. Comments may be sent by February 22, 1994, to the Board of Governors of the Federal Reserve System, William W. Wiles, Secretary, 20th Street and Constitution Avenue N.W., Washington D. C. 20551. For a copy of the complete proposal, call Anne Guthrie (314) 444-8810.

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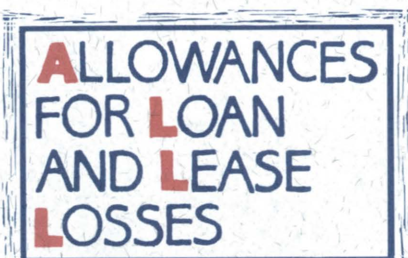
Uniform ALLL Policy Adopted

The federal banking agencies have adopted a uniform interagency policy for determining the adequacy of the allowance for loan and lease losses (ALLL). The policy affirms the responsibility of the bank's board of



directors and management for maintaining the ALLL at an adequate level. The policy also establishes a minimum standard for all institutions. For regulatory reporting purposes, an adequate ALLL will ordinarily be no *less* than the losses in classified loans as estimated over their remaining life and the risks in unclassified credits as estimated over the upcoming year.

Analysis of Loan and Lease Portfolio

In analyzing the adequacy of the ALLL, banks should segment the portfolio into as many components as practicable. Each component should have certain common characteristics, such as risk classification, past-due status, type of loan, industry or collateral. The evaluation of each loan, or pool of loans, should reflect consideration of all significant factors that affect its collectibility. In determining the allocation for loss in credits, banks must refer to the recently adopted FASB 114, which provides a standard for calculation of loss in impaired credits. (See article on back page.)

Historical loss experience provides a reasonable beginning for analyzing the institution's ALLL adequacy. Alone, however, it is insufficient when estimating the credit risk in grouped loans. In addition, risk analysis must be tempered by factors that include:

- changes and developments in economic and business conditions;
- changes in the trend of the volume and severity of past-due and classified loans; and
- the existence and effect of any concentrations of credit and changes in the level of such concentrations.

Institution-specific factors that should affect evaluations of the ALLL adequacy are changes in lending policies and procedures; changes in the experience, ability and depth of lending management and staff; and changes in the quality of the institution's loan review system.

The policy encourages banks to use aggregate measures as a reasonableness check of its overall estimate of the ALLL. Aggregate measures may include ratios such as the ALLL to past-due and nonaccrual loans, total loans and peer comparisons.

Examiner Responsibility

Examiners are responsible for reviewing the comprehensiveness of the evaluation, the consistency and appropriateness of the methodology applied, and the sufficiency of supporting documentation. In addition, they will test ALLL adequacy by calculating a measure that deducts loans classified as a loss; weighting loans classified as doubtful and substandard at 50 percent and 15 percent, respectively; and adding to this sum an annualized loss amount, which relates to the remaining unclassified segment of the loan portfolio.

Examiners will generally accept management's estimates when management has maintained effective systems and controls for identifying, monitoring and addressing asset quality problems in a timely manner; analyzed all significant factors that affect the collectibility of the portfolio in a reasonable manner; and adopted an acceptable ALLL evaluation process.

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Program Monitors Accuracy of Regulatory Reports

Effective with the September 30, 1993, reporting date, the Federal Reserve System implemented the second phase of the Regulatory Reports Monitoring Program. This phase monitors regulatory reports, including the call, bank holding company, and Home Mortgage Disclosure Act (HMDA) reports, submitted with mathematical errors or omissions of required schedules and other information.

The following suggest ways to further enhance data quality.

Financial Reports

Precision

- Verify that components sum to the total.
- Review income statement items for correct reporting of negative entries since the reports are designed to reduce the need for negative figures. For example, although the income tax expense reduces net income, it should be reported as a positive entry. An income tax benefit, however, increases net income and should be reported as a negative entry.
- Report balances on line items that indicate "less" as a positive entry since negative entries are usually incorrect.
- Review the FR Y-9LP Cash Flow Statement (Schedule PI-A) for correct reporting of negative entries.

Consistency

- Verify correct reporting of items on the Call Report and the FR Y-9C requesting data from the previous December 31 report. Also, ensure that income and expense figures do not decline from the previous quarter.
- Cross reference figures reported on the balance sheet and income statement to the supporting schedules. For example, verify that amounts reported for each loan category on the past-due and nonaccrual schedule do not exceed the total amount outstanding for a particular loan type.

Completeness

- Verify that all information is provided, including those items that require a "YES" or "NO" response.

HMDA Reports

- Confirm that current maps are used to geocode properties since most of the HMDA-related errors are a result of incorrect property location information.

Contact the U.S. Census Bureau for information regarding the reporting of property location.

Currently, over half of Eighth District banks and bank holding companies use mainframe or PC software to produce regulatory reports. This Reserve Bank has noted that institutions editing data and subsequently filing electronically have overall better data quality. Institutions filing electronically, however, are required to maintain a signed hard copy for examiner review.

To obtain a checklist or information about electronic filing, call Frank Bufe at (314) 444-8750. For questions concerning HMDA, call Bob Dowling at (314) 444-8532.

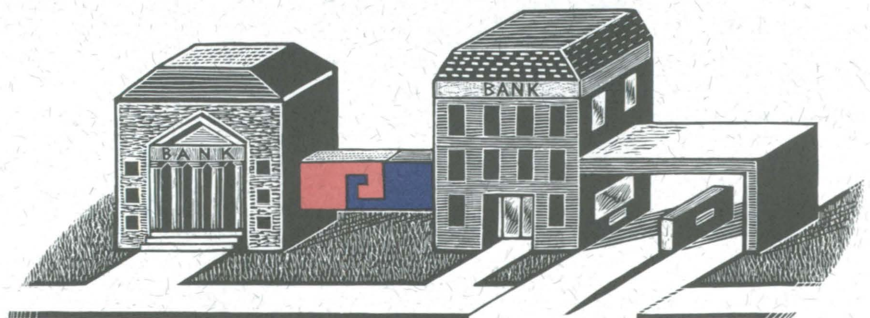
New Reg L Exemption Expected

The federal banking agencies are adopting a new exemption to the prohibitions of Regulation L — Management Official Interlocks. The exemption, as proposed, permits management interlocks between depository organizations that control between them less than 20 percent of the deposits in a community or a Relevant Metropolitan Statistical Area (RMSA). The exemption will apply as long as the organizations involved:

- do not control more than 20 percent of the deposits in another community or RMSA; and
- do not fall within the major assets provision of the regulation, which prohibits interlocks between institutions with assets over $1 billion and institutions with assets over $500 million, regardless of location.

If the level of deposit control exceeds 20 percent in the community or RMSA, the institution will have 15 months to address the prohibited interlock.

Interlocks established prior to November 10, 1978, that were grandfathered may continue if the new exemption covers them. To confirm continuation, discuss the situation with your primary supervisor. At this Reserve Bank, call either Timothy A. Bosch, Assistant Vice President — Western Region, at (314) 444-8440, or Kim D. Nelson, Assistant Vice President — Eastern Region, at (314) 444-8735.



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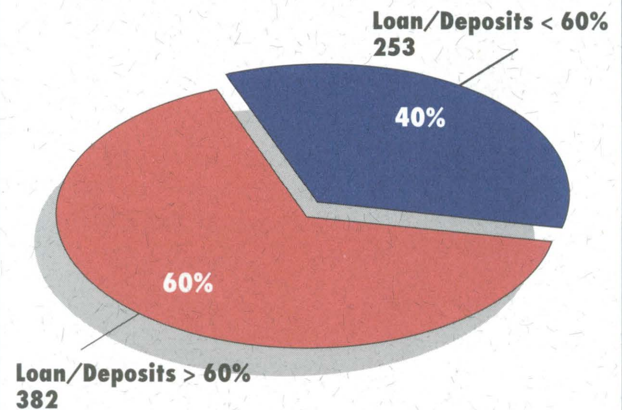
BANK PERFORMANCE

Retail Lending Spurs District Loan Growth

District total loan volume grew at an annual rate of 8.2 percent during the first nine months of 1993 as compared to 4.8 percent during the same period in 1992. While loans grew across all lending categories, mortgage lending, commercial and industrial loans, and consumer credit showed the greatest increase.

Real estate-secured loans exhibited the largest increase, 8 percent year-to-date 1993. As of September 30, this category accounted for 53 percent of the District loan portfolio. Within this category, residential mortgage loans, junior liens and home equity lines of credit showed the largest increases. This factor, coupled with increases in consumer loans, indicates that District banks are continuing to focus on retail lending. Nonetheless, commercial and industrial loans grew by 2.5 percent in the first nine months of 1993.

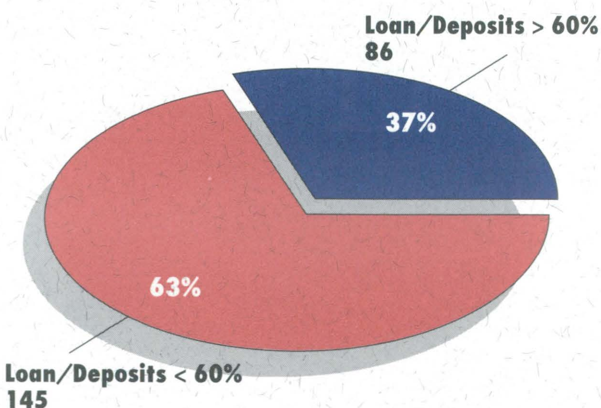


Excludes banks owned by BHCs with banking and thrift assets > $250 million.

The District's largest banks, those with assets in excess of $1 billion, accounted for 40 percent of District banking assets and held a like amount of the District's total loan base. Loan growth among these 20 banks equaled 11.9 percent year-to-date 1993 and accounted for 75 percent of the District's total loan growth. As expected, these banks hold a higher level of commercial and industrial loans constituting, in the aggregate, over 25 percent of their loan portfolios.

The increase in loan growth has resulted in an increase in the District's loan-to-deposit ratio to 69.6 percent as of September 30. Because loans have grown faster at larger institutions, loan-to-deposit ratios among small banks are lower.

This lower loan-to-deposit ratio affects the number of institutions with assets less than $250 million that would be eligible for the small-bank assessment program outlined in the CRA proposal. (See article on page 1.) Thus, while there are 231 District banks eligible for the program based on asset size, only 86 now have a loan-to-deposit ratio that would qualify them for a satisfactory rating under the proposal. Similarly, although there are 635 banks affiliated with bank holding companies eligible for the program, only 382 report a 60 percent loan-to-deposit ratio.



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FASB 114 and the ALLL

FASB Statement No. 114, which addresses accounting by creditors for impaired loans, affects estimates of credit losses for the allowance for loan and lease losses (ALLL). Effective for fiscal years beginning after December 15, 1994, the new standard will require that estimates of credit losses be calculated on a present-value basis.

Calculation of Impairment

This estimate will be calculated by discounting the estimated future cash flows of each applicable loan at its contractual rate. The difference between the contractual amounts due and the discounted amount will represent impairment. The standard, however, will not prescribe a particular method for estimating future cash flows. Moreover, these amounts are not intended to represent the minimum that an institution should maintain in its overall ALLL.

Accrual of Interest on Impaired Loans

Currently, the balance in the ALLL represents the potential uncollectibility of loan principal balances. With the adoption of FASB 114, the balance in the ALLL will also reflect potential uncollectibility of loan interest. Because of this new accounting treatment, FASB 114 will permit the accrual of interest on impaired loans, regardless of their past-due status.

Coverage

The new standard will not apply to all loans. Residential mortgage, credit card and consumer installment loans will not be subject to FASB 114.

The Federal Reserve and other banking supervisors are developing interagency guidance on the application of FASB 114 in the ALLL evaluation process and other supervisory issues connected with this accounting standard.

Clarification

The November issue contained a misprint in the "Flood Claims Reflect Limited Protection" article. The first sentence of the last paragraph in the second column should read:

"Additionally, lenders that are regulated by the Fed may 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."

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12A ACCOUNTING
HILLARY DEBENPORT

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