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MAY 1 1 1994

May 1994

Supervisory
News and Views
for the Eighth District

SUPERVISORY ISSUES

Nondeposit Investment Risk Must be Clear

Recently issued uniform guidelines on retail sales of nondeposit investment products are intended to ensure that bank customers understand that these products carry investment risk. The guidelines apply to mutual fund, annuity and other nondeposit investment product retail sales programs, whether offered directly by employees of the institution or indirectly through employees of a third party. They apply to sales occurring on the premises of the institution and sales through referral of retail customers to off-premises third parties when the institution receives a benefit for the referral. The guidelines generally do not apply to sales of such products to non-retail customers such as fiduciary accounts administered by the institution.

Disclosure Requirements

Advertising and sales practices for nondeposit investment products must be accompanied by certain disclosures to ensure that these products are clearly differentiated from insured deposits. Disclosures must be clear and conspicuous and, at a minimum, specify that the product is:

- not insured by the FDIC;
- not a deposit or other obligation of, or guaranteed by, the depository institution; and
- subject to investment risk, including possible loss of the principal amount invested.

These minimum disclosures should be provided:

- in advertisements and other promotional materials;
- orally during any sales presentations;
- orally when investment advice concerning nondeposit investment products is provided; and
- orally and in writing prior to or at the time an investment account is opened to purchase these products.

A statement, signed by the customer, should be obtained at the time such an account is opened, acknowledging that the customer has received and understands the disclosures.

Confirmations and account statements should contain at least the minimum disclosures if the confirmations or account statements display the name or logo of the bank or an affiliate. If a customer's periodic deposit account statement includes information concerning the customer's nondeposit investment products, the information must be clearly separate from deposit account information and should be introduced with the minimum disclosures

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Investment Risk

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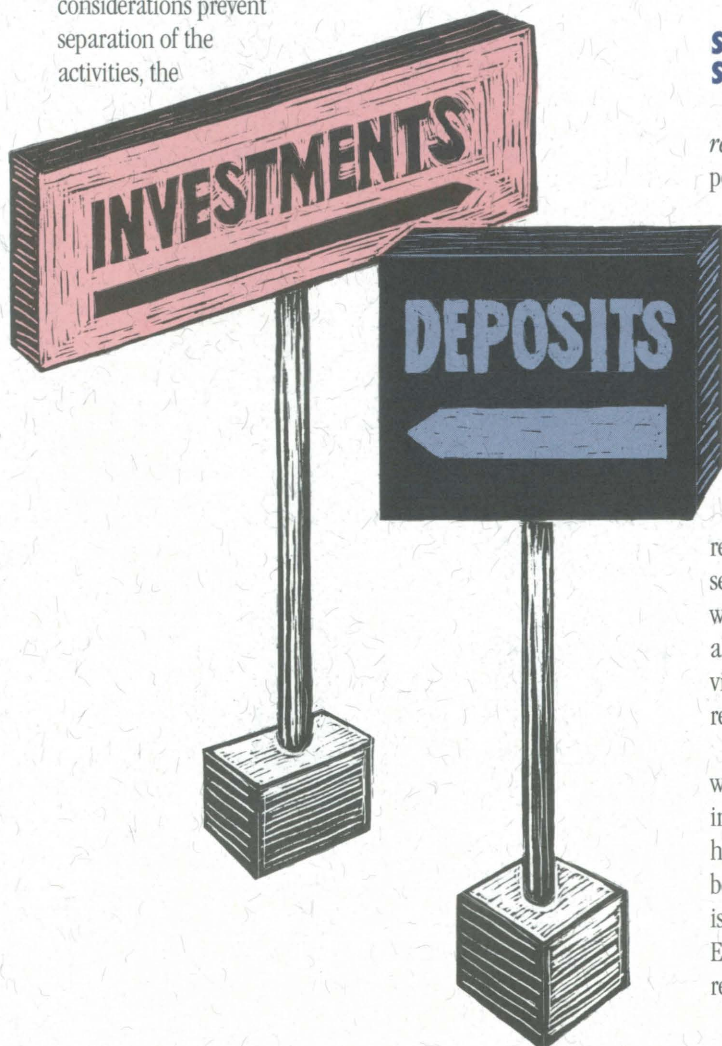
and the identity of the entity conducting the nondeposit transaction.

Separation of Deposit and Nondeposit Transactions

To minimize customer confusion with deposit products, sales or recommendations of nondeposit investment products on the premises of a bank should be conducted in a physical location distinct from the area where retail deposits are taken. Signs or other means should be used to distinguish the investment sales area from the retail deposit-taking area of the institution. If physical considerations prevent separation of the activities, the institution has an increased responsibility to ensure that appropriate measures are in place to minimize customer confusion.

Tellers and other employees located in the routine deposit-taking areas, such as the teller window, may not make general or specific investment recommendations regarding nondeposit investment products, qualify a customer as eligible to purchase such products, or accept orders for such products, even if unsolicited. Tellers may refer customers to individuals who are authorized to assist in the purchase of such products. Bank employees, including tellers, may receive a one-time nominal fee in a fixed dollar amount for each customer referral for nondeposit investment products. The payment of this fee should not depend on whether the referral results in a transaction.



Advertising and sales practices must be accompanied by disclosures to ensure that products are clearly differentiated from insured deposits.

Sales Practices and Suitability

Employees authorized to *recommend or sell* nondeposit investment products or to provide investment advice must be adequately trained and supervised. Training should impart a thorough knowledge of the products, applicable legal restrictions on purchase and sale, and customer protection requirements. Employees recommending or selling securities must have training which is the substantive equivalent of that required for individuals selling securities as registered representatives.

In addition, employees who *recommend* nondeposit investment products must have reasonable grounds for believing the specific product is suitable for the customer. Employees should make reasonable efforts to obtain directly from the customer information which includes, at a minimum, the customer's financial and tax status, investment objectives and other information that may be useful or reasonable in making investment recommendations to that customer. This information should be documented and updated periodically.

Personnel authorized to *sell* products may receive incentive compensation, such as commissions, for sales transactions. These programs, however, must not be structured in a way which results in unsuitable recommendations or sales being made to customers.

Compliance and audit personnel should not receive incentive compensation directly related to the results of nondeposit investment sales programs.

Compliance Procedures

A bank engaged in these activities should develop a written policy, formally adopted by its directors, that addresses the risks involved with the sales program. The statement should contain procedures addressing, at a minimum, the concerns addressed in the guidelines. The Federal Reserve is testing examination procedures which measure compliance with these guidelines.

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Revised Regulation O Intended to Reduce Regulatory Burden

Regulation O, which limits loans by a bank to its insiders and executive officers, has been recently revised to reduce the burden and complexity of its provisions. The revision narrows the definition of "extension of credit" and provides

additional exemptions for calculating the limits on insider credit and loans to executive officers. In addition, it reduces recordkeeping requirements and makes permanent the interim rule increasing the aggregate insider loan limit for small banks to 200 percent of capital and surplus.

Revisions to the Definition of "Extension of Credit"

First, the "tangible economic benefit" rule was clarified to clearly exempt *arm's length* extensions of credit by a bank to a third party where the proceeds of the credit were used to finance a bona fide acquisition of property, goods or services from an insider or an insider's related interest. For example, a home improvement loan to a bank customer is not subject to Regulation O restrictions even if the loan proceeds are paid to an insider's construction company for performing the work. The "tangible economic benefit" rule, however, does cover extensions of credit to an insider's nominee and transactions in which the proceeds of the credit are loaned to an insider.

Secondly, a bank's purchase of loans, conditional sales contracts and similar paper from an insider *without recourse* is no longer an extension of credit.

Lastly, the threshold above which credit card loans to insiders are considered extensions of credit has been raised from $5,000 to $15,000. The threshold for extensions of credit through overdraft plans, however, *has not* been raised. As a result, loans to insiders under overdraft protection plans in excess of $5,000 are still considered "extensions of credit."

Loans to Executive Officers

Loans to executive officers that are fully secured by: (a) obligations of the United States or other obligations fully guaranteed as to principal and interest by the United States; (b) commitments or guarantees of a department or agency of the United States; or (c) a segregated deposit account with the lending bank are now exempt from the general purpose lending limit to executive officers. This limit provides that lending to executive officers is generally limited to the greater of $25,000 or 2.5 percent of its equity capital plus its reserve for loan losses, but in any case may not exceed $100,000. Loans to executive officers for the purposes of purchasing, constructing, maintaining or improving their principal residences, or to finance the education of their children, however, are not counted toward this limit.

Revisions were also made to clarify that a *refinancing* of a mortgage loan was included

Revisions narrow the definition of "extension of credit" and allow additional exemptions for calculating the limits on insider credit and loans to executive officers.

in the exception to the extent that the proceeds are used to pay off a prior home mortgage loan or for purchasing, constructing, maintaining or improving an executive officer's residence. Nevertheless, loans to executive officers for

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such purposes must be approved in advance by the bank's board of directors.

Recordkeeping Requirements

Recordkeeping requirements for banks have been reduced. Banks still must survey annually their own officers and directors, but are no longer required to survey officers and directors of affiliates in a holding company organization. To monitor the limits on credit to insiders of the bank's affiliates, the bank may either 1) identify, through an annual survey, each insider of each affiliate or 2) require that each borrower identify whether or not he or she is an insider of an affiliate of the bank. In either case, the bank must continue to maintain records that identify the amount and terms of each extension of credit by the member bank to individuals and companies identified under either approach. While the regulation permits other recordkeeping methods, a bank electing a different method must establish to the satisfaction of the examiner that the different method is equally effective.

Every bank should have a monitoring system which tracks individual and aggregate borrowing limits.

Of importance to examiners is that every bank has a monitoring system which tracks individual and aggregate borrowing limits, and that board minutes properly record the required approvals. During each examination, it is normal practice for all insider loans to be reviewed for credit quality and compliance with Regulation O.

Revised Policy Statement on Securities Activities

The FFIEC has issued interim revisions to the interagency policy statement on securities activities of banks. The revisions address the section of the policy statement relating to mortgage derivative products to assure consistency with the new FASB 115. The major revisions are:

- Mortgage derivative products that are "non-high risk" when purchased but later become "high-risk" do not have to be redesignated as available-for-sale or as trading assets. Examiners are further instructed to consider any unrecognized net depreciation in held-to-maturity high-risk securities when they evaluate the adequacy of an institution's capital.

- High-risk mortgage securities acquired to reduce interest rate risk, but which no longer serve this purpose due to changes in interest rate positions, may not be reported as held-to-maturity securities at amortized cost. In addition, examiners may require that such securities be sold, if they determine that the continued ownership of the high-risk mortgage securities represents an undue safety and soundness risk to the institution. This risk can arise from the size of the institution's holdings of high-risk mortgage securities in relation to its capital and earnings, management's inability to demonstrate an understanding of the risks inherent in such securities and to manage overall interest rate risk, inadequate internal monitoring systems and other internal controls to measure market and cash flow risks, in addition to other factors.

These revisions will remain in effect until the entire policy statement is revised to conform to FASB 115.

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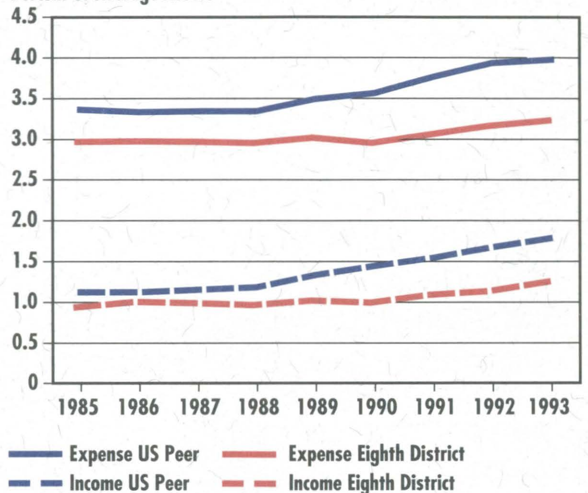
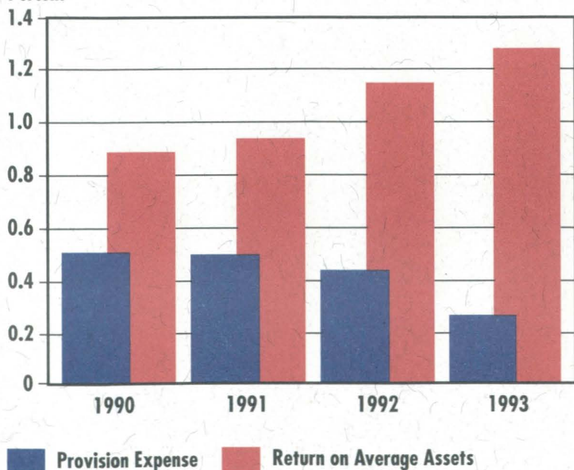
BANK PERFORMANCE

District Banks Earned Record Profits in '93

District banks earned a record $1.9 billion in 1993, a 16.8 percent increase over earnings reported for 1992. With the exception of a few billion dollar banks and those under $25 million, banks across the District generated aggregate returns on average assets (ROAA) in excess of 1 percent, leading to an aggregate ROAA of 1.27 percent for the entire District. U.S. peer banks less than $15 billion reported a 22 percent increase in 1993 earnings, matching for the first time the District's 1.27 percent aggregate return on average assets.

Lower provision expense for loan losses was the primary contributor to earnings.





Provision expense has been declining since 1990, but the deep cuts made in 1993 added an average 17 basis points to the aggregate pre-tax ROAAs for District banks. The cuts in provision expense follow significant improvements in asset quality. Net loan losses were reduced by half over the past two years and aggregated .36 percent of total loans for the District. Although U.S. peer banks reported net loan losses twice that amount, their levels of past due and nonaccrual loans continued to decline. Past due and nonaccruals equalled a moderate 3.02 percent of total loans at year-end, and loan loss reserves now provide $1.22 for every dollar in noncurrent loans, defined as loans past due 90 days or more or on nonaccrual status.

As usual, District banks retained high asset quality, reporting aggregate past due and nonaccrual loans at 2.08 percent of total loans and $2.06 in loan loss reserves for every dollar in noncurrent loans. In addition, banks sharply reduced their holdings of other real estate during the year.

An additional $264 million earned in the District through various sources of noninterest income also contributed to earnings growth. Banks reported aggregate noninterest income of 1.29 percent of average assets compared to

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Bank Performance

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1.17 percent in 1992. Half of the additional revenue was derived from other fee income, with increases also reported for all other noninterest income, service charges and net trading gains; income from fiduciary activities declined 6 percent.

Increases in all categories of overhead, however, largely mitigated the gains previously noted for most District banks. Conversely, most U.S. peer banks and approximately one-third of all District banks did report improvements in their net noninterest expense/average assets ratio. On an aggregate basis, improvement in the net overhead ratio added 5 basis points to the pre-tax ROAAs for banks under $15 billion.

All banks experienced stronger net interest margins in 1992; however, only District banks over $1 billion benefitted from a stronger margin in 1993. In fact, these banks' margins were augmented an average 22 basis points due to declines in interest expense, more than offsetting declines in interest income. U.S. peer banks and all other District banks realized no change or a slight squeeze in their margins for the opposite reason; declines in interest income moved in tandem with or more than offset declines in interest expense.

District interest income continued to be limited by declining yields on loans and notably securities; even so the District reported aggregate loan growth of 9.6 percent. Loan growth was funded primarily by deposits and other borrowings, and to a lesser extent profits. This greatly exceeded loan growth by U.S. peer banks of 2.7 percent. Overall, the District's assets grew a moderate 5.0 percent, compared to a flat .8 percent growth by U.S. peer banks.

Certainly, both District and U.S. peer banks are well-positioned for 1994, with the past two years of declining interest rates strengthening margins and balance sheets.

FFIEC Offers Fair Lending Seminars

Three, one-day fair lending seminars are scheduled to be held throughout the country in 1994 for presidents, chief executive officers and directors of financial institutions. The seminars are intended to assist top management to better understand fair lending issues and institute policies that ensure corporate commitment to nondiscriminatory lending practices.

Each seminar will emphasize the fair lending priorities of the agency principals and the initiatives underway to carry them out, the role of the Justice Department and the Department of Housing and Urban Development in enforcing the fair lending laws, secondary market standards and their effect on institutional fair lending, and successful ways lenders have improved their fair lending practices.

Complete the enclosed application form to register. Early registration is recommended because space is limited.

Post Office Box 442
St. Louis, Missouri 63166

Supervisory Issues is published bimonthly 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 Kathleen Y. Poniewaz, editor, 314-444-4634.

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