



SUPERVISORY ISSUES

July 1994

Supervisory
News and Views
for the Eighth District

Real Estate Appraisal Amendments Adopted

The federal banking agencies issued final amendments, effective June 7, 1994, to the appraisal regulations for federally related real estate transactions. The most significant amendment raises to \$250,000 the transaction amount at or below which qualified appraisals are not required. In addition, the amendments clarify the following exemptions and revise minimum appraisal standards.

The "Abundance of Caution" Exemption

A lender is now permitted to

take a lien against real estate and alter the price of a loan without an appraisal of the real property if the institution determines that the borrower's current income and other pledged collateral support the decision to extend credit.

The final rule requires five minimum appraisal standards instead of fourteen.

An example would be a business with established cash flow that applies for a loan to purchase an adjacent property for expansion. The lender's analysis, without market value knowledge of the real estate, determines that income from the business and personal property available as collateral supports the decision to extend credit. During loan negotiations, the lender offers the loan on slightly better terms if it receives a lien on real estate. Since the decision to extend credit rests on income and other collateral, no qualified appraisal is required.

Loans Not Secured by Real Estate

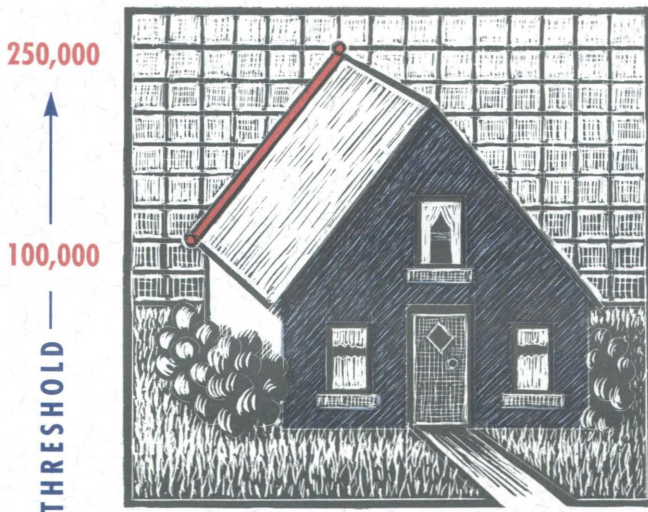
In connection with a credit extension to acquire or invest in real estate, a qualified appraisal is not required if the lender does not take a security interest in the real estate.

Renewals and Refinancings

Lenders may renew or refinance existing credit extensions without qualified appraisals for the following transactions:

- There are no obvious or material changes in market conditions or the physical aspects of the property that threaten the adequacy of the lender's collateral protection, even with the advancement of new funds.
- No new monies are advanced other than funds necessary to cover closing costs.

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Real Estate Appraisal

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This exemption does not apply if the borrower refinances a mortgage with a new lender.

Small Business Loans of \$1,000,000 or less

Small business loans secured by real estate need not be supported by a qualifying appraisal if real estate sales and/or rental income are not the primary source of repayment. For example, a retail store applies for a working capital/inventory loan of \$750,000 which will be repaid from sales proceeds. The lender, however, will not extend credit without a lien against the store's real property. The loan is for less than \$1,000,000 and the sale of, or rental income derived from, the real estate is not the anticipated repayment source. Therefore, a qualifying appraisal is not required.

Government Guaranteed Loans

Qualified appraisals are no longer required for transactions

that are wholly or partially insured or guaranteed by a United States government agency or government-sponsored agency.

An evaluation provides a general estimate of the value of the real estate and must contain sufficient information to make a prudent credit decision.

Minimum Appraisal Standards

The final rule requires the following five minimum appraisal standards in place of the 14 standards in the prior rule:

1) Appraisals must conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) unless principles of safe and sound banking require compliance

with stricter standards;

- 2) Appraisals must be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction;
- 3) Appraisals must analyze and report deductions and discounts for proposed construction or renovation, partially leased buildings, nonmarket lease terms, and tract developments with unsold units;
- 4) Appraisals must be based on the definition of market value as set forth in the regulation; and,
- 5) Appraisals must be performed by state-licensed or certified appraisers.

The minimum standards also permit lenders to use appraisals prepared in accordance with the USPAP Departure Provision for federally related transactions.

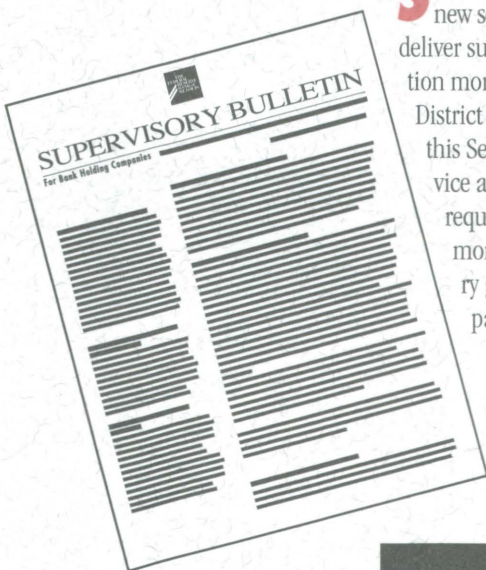
Evaluations Required for Certain Exempt Transactions

Lenders must obtain evaluations for real estate-related transactions that do not require qualified appraisals if the loans are below the threshold level, qualify for the business loan exemption, or qualify for the renewal/refinancing exemption.

An evaluation provides a general estimate of the value of the real estate and must contain sufficient information to make a prudent credit decision.

The agencies are revising existing guidance on real estate appraisal and evaluation programs to address the changes made by these amendments.

New Service to Improve Supervisory Information



Supervisory Bulletin, a new service designed to deliver supervisory information more effectively to District bankers, will begin this September. The service addresses bankers' requests that we provide more specific supervisory guidance and less paper.

The service will provide all supervisory guidance and policy statements affecting institu-

tions supervised by this Reserve Bank in an easy to read, two-column format. Three-ring binders will be provided for retention. The service will be indexed at least annually to provide a ready reference source. Each Eighth District state member bank and bank holding company will receive the service at no charge. The service is intended to replace all supervisory mailings from this Reserve Bank.

An improved distribution service for Federal Reserve

regulations is also being designed and will be available January 1, 1995. In addition, in the future, information from both services will be delivered electronically over FRED, the Eighth District's electronic bulletin board.

RESPA Applies to New Transactions

The Department of Housing and Urban Development has amended its regulation implementing the Real Estate Settlement Procedures Act (RESPA) to include additional forms of credit added by Congress in 1992. The regulation is known as Regulation X; it differs from the Fed's Regulation X which governs securities credit

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transactions. RESPA now applies to any loan secured by a lien on 1-to-4 family residential property. New transactions covered by these amendments include home equity plans, refinancings and dealer loans. The changes are effective August 9, 1994, except as otherwise noted.

Home Equity Lines of Credit

RESPA now covers home equity plans. However, lenders who provide borrowers with the Regulation Z disclosures at the time of application also satisfy obligations under RESPA and are not required to provide the borrower with a good faith estimate or a HUD settlement statement.

Dealer Loans

A dealer consumer credit contract, such as a home improvement loan, secured by residential real estate and originated with the intent of subsequent assignment of the dealer's interest, is covered by RESPA as a "federally related mortgage loan." Under this arrangement, a dealer advances credit to the borrower based on the lender's prior agreement to fund the loan upon completion or delivery of goods and services, with the net proceeds to be paid to the dealer. RESPA requires that the funding lender ensures that the borrower receives the necessary disclosures, such as the good faith estimate and a HUD settlement statement.

Refinancing Transactions

Refinancings which are

covered by Regulation Z are now also covered by RESPA. Thus, RESPA applies if a new obligation is created to replace an existing obligation with the same lender and no transfer of title is involved. However, the revised regulation provides that a refinancing transaction is exempt from RESPA if it is a modification of an existing obligation with the same borrower therefore no good faith estimate or settlement statement is needed. This exemption does not apply if the modification is a change from a fixed term obligation to a variable rate obligation.

Exempt Transactions

The changes also include exemptions which were effective March 14, 1994:

- 1) Loans on property of 25 acres or more**
Transactions involving liens on all properties of 25 acres or more are now exempt, whether the property is vacant, used for agricultural purposes or a 1-to-4 family residence.
- 2) Business-purpose loans**
Loans secured by 1-to-4 family residential property made to corporations, associations, partnerships and trusts are exempt; similar loans made to individuals are covered.
- 3) Vacant or Unimproved Property**
Loans secured by vacant or unimproved property are exempt as long as lenders assure themselves that the purpose of the loan

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is not to add or construct a 1-4 family residential structure out of loan proceeds within two years from settlement of the loan.

4) Temporary Financing

The final rule clarifies that so-called “bridge” or “swing” loans, which are short-term loans to facilitate a person who is selling

a property and buying another to cover interim obligations, are not covered RESPA transactions.

5) Assumption without lender approval

If lender approval of the assumption is not required by the mortgage instruments, the transaction is exempt from RESPA.

6) Loan Conversions

Any conversion of a federally related mortgage loan to different terms than the original mortgage instruments, as long as a new note is not required, even if the lender charges an additional fee for the conversion, is not covered.

Accurate Tax Equivalency is Important in Assessment

Errors in reporting tax equivalent net interest income on bank holding company Y-9 reports result in inaccurate information about a company’s core earnings. Regulators, investors, creditors and the general public use this information to assess the company’s operating performance, the effectiveness of its asset mix, and its pricing of loans and deposits. These assessments can affect the company’s stock price,

loan terms from creditors and the degree of regulatory oversight of the bank holding company and its subsidiary banks. Some of the most frequent reporting errors include:

- reporting tax equivalent income as being equal to net income or as being equal to net income before taxes;
- subtracting or adding total tax-exempt income to net interest income; and,

- failing to report all classes of tax equivalent items.

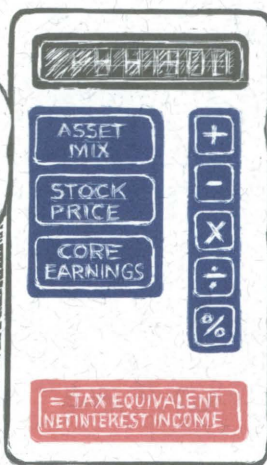
Tax equivalent net interest income is net interest income adjusted to reflect the tax-exempt status of certain loans and securities. It is reported quarterly by holding companies

with consolidated assets over \$150 million on Y-9C, Schedule HI, Memoranda Line Item 1.

Proper reporting of tax equivalent net interest income allows for an accurate assessment of historical trends and peer group comparisons.

Follow these steps to report tax equivalent net interest income correctly. If reported net interest income equals \$100,000:

- 1) Add all interest income that is exempt from federal taxation. 1) \$10,000
- 2) Subtract the marginal federal tax rate from 1.00. 2) $1.00 - 0.35 = 0.65$
- 3) Divide the sum of exempt income (as identified in step 1) by the result in step 2. 3) $\$10,000 \div .65 = \$15,384$
- 4) Subtract the sum of tax-exempt income (as identified in step 1) from the amount obtained in step 3. 4) $\$15,384 - \$10,000 = \$5,384$
- 5) Add the amount calculated in step 4 to reported net interest income. This amount represents tax equivalent net interest income. 5) $\$5,384 + \$100,000 = \$105,384$



BANK PERFORMANCE

FASB 115 Affects District Bank Balance Sheets

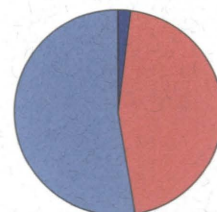
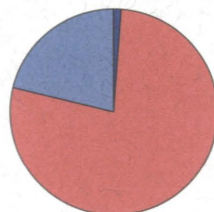
District banks responded to the regulatory reporting requirements implementing FASB No. 115 by shifting a large volume of securities from Held to Maturity accounts to Available for Sale accounts. In addition to a more rigorous requirement that securities be classified based on investment intent, the new rule provides that net unrealized gains and losses for securities recorded at fair value and Available for Sale be captured in a new equity account.

As the pie charts indicate, call reports for the first quarter of 1994 reveal that over 30 percent of all securities held by District banks shifted into Available for Sale accounts. A similar shift occurred in all U.S. banks with total assets less than \$10 billion.

Securities Held by Eighth District Banks

December 31, 1993

March 31, 1994



■ Trading ■ Held to Maturity ■ Available for Sale

While the dollar amount of securities in Available for Sale accounts increased between December 31 and March 31, total net unrealized gains for those securities declined. As of December 31, the 146 banks holding 30 percent of District securities which had adopted the new rule reported net unrealized gains of \$80 million. By March 31, net unrealized gains for all banks in the Available for Sale accounts had declined to \$14.8 million.

Community banks in the District with total assets of \$250 million or less experienced less decline in net unrealized gains in the Available for Sale accounts than large banks with total assets greater than \$250 million but less than \$10 billion. Community banks watched their net unrealized gains decline by \$2 million from year-end 1993, leaving a balance at March 31 of \$15.3 million. Large banks

saw the appreciation in their Available for Sale accounts decline by \$63 million, leaving them with \$546 thousand in net unrealized losses at March 31.

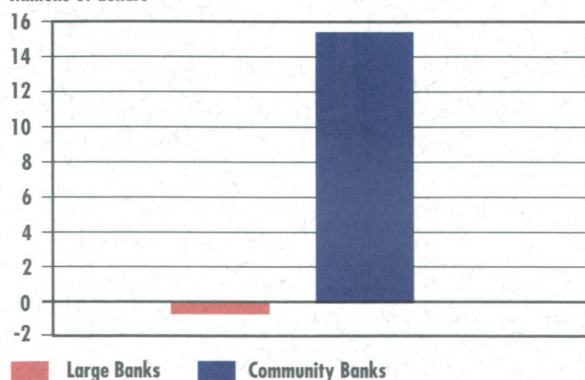
As of March 31, 1994, the \$14.8 million in net unrealized gains for all District banks represented only two-tenths of 1 percent of total equity, compared to net unrealized losses on a nation-wide basis of four-tenths of 1 percent. The decrease in net unrealized gains affected community banks' equity by less than one-tenth of 1 percent and the equity of large banks by only nine-tenths of 1 percent.

Until the banking agencies determine how this new account is treated for purposes of regulatory capital, unrealized gains and losses on Available for Sale securities should not be included in Tier 1 capital.

Net Unrealized Gains and Losses

March 31, 1994

Millions of dollars



Fed Announces Initiatives to Decrease Regulatory Burden

The Federal Reserve recently announced two initiatives to increase examination efficiency and decrease the need for regulatory approvals.

Reserve Banks will now offer all state member banks the option of having electronic data processing, trust and other specialized examinations conducted concurrently with safety and soundness

examinations. A coordinated examination may increase the demand on a bank's space and staff during an examination. The total time spent meeting the requirements of various Federal Reserve examinations, however, should decrease.

In addition, the Board of Governors recently amended Regulation H to allow a state member bank to increase its

investment in bank premises without obtaining specific approval. The provision is not available to a bank which is not well-capitalized, has a

satisfactory supervisory rating, or is subject to formal corrective action.

FFIEC Information Systems Handbook is Available

The 1994 FFIEC Information Systems Handbook is the result of an interagency effort to achieve uniformity in EDP examination procedures. Financial institutions and the general public may purchase the handbook for \$25. To

order, indicate the quantity desired and enclose payment to:

The Board of Governors of the Federal Reserve System
Publication Services
Mail Stop 127
Washington, D.C. 20551

Are there others who should be reading this?

If you would like additional copies of *Supervisory Issues*, please call Kathleen Poniewaz at (314) 444-4634.



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