



# SUPERVISORY ISSUES

November 1994

Supervisory  
News and Views  
for the Eighth District

## Board Streamlines Nonbanking Applications Procedures

The Board of Governors has amended Regulation Y to implement the section of the Community Development and Regulatory Improvement Act of 1994 (CDRIA) which streamlines the approval process for bank holding companies seeking to engage in nonbanking activities. The amendments provide simplified 30- and 60-day

acquisition of a going concern, are now made by a 30-calendar day notice. The new regulation contemplates action by the Reserve Bank within *30 calendar days of receipt of a notice containing all core information*. Also, the *Federal Register* public comment period for these proposals has been reduced from 30 to 15 days.

The Reserve Bank may request additional information within five business days after receiving a notice. Clearly deficient notices may be returned within 15 calendar days after receipt. This 30-day processing period may be extended 15 calendar days by the Reserve Bank if the notificant is advised of the reasons.

The current procedure for "small acquisitions" of companies engaged in listed activities has been retained. The maximum size limitation for a small acquisition, however, has been increased from \$100 to \$300 million in total assets.

prior notice periods. In most cases, pre-acceptance review of notices has been eliminated.

### 30-Day Notice

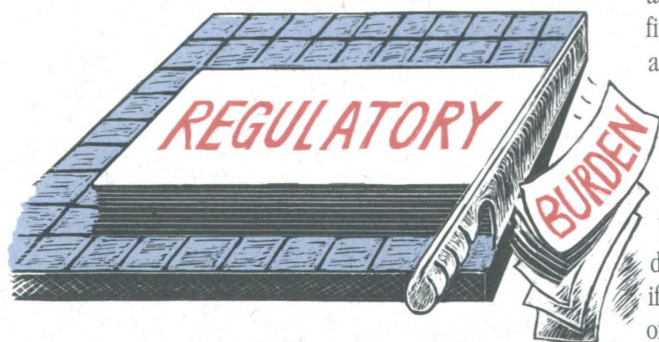
Proposals to engage in nonbanking activities *listed* in Section 225.25(b) of Regulation Y, either de novo or through

### 60-Day Notice

Proposals by holding companies to engage in nonbanking activities *not listed* in Section 225.25(b) of Regulation Y (unlisted activities) are now also made by prior notice. The new regulation contemplates action by the Board of Governors within *60 calendar days after receiving a notice containing all core information*. This procedure also applies to proposals involving listed nonbank activities that, because of other issues, are not eligible for delegated processing. Requests for information, in addition to that which is required by the regulation, will be sent to the notificant within 10 business days after receiving a notice. Clearly deficient notices may be returned within 15 calendar days.

The initial processing period can be extended for 30 calendar days, and the Board may extend an additional 90 calendar days for a total extension equaling 120 calendar days as long as the institution is advised of the reasons for the extension.

(continued on next page)



## Applications Procedures

(continued from front page)

If 60 calendar days elapse after receipt of a *complete* notice, and the Board has not issued an order of disapproval or the processing period has not been extended, the notice will be deemed approved by operation of law. For this provision only, a complete notice is defined as containing all information required by the regulation *and all other requested information*.

### Core Information

A notice to engage de novo in a *listed* nonbanking activity, either directly or through a subsidiary, must contain at least the following information:

- 1) a description of the proposed activity;
  - 2) the identity of the company to conduct the activity; and
  - 3) a description of existing activities of the subsidiary, if the institution proposes to conduct activities through an existing subsidiary.
- A notice to acquire a *going concern* engaged in a *listed* nonbanking activity must also include these items:
- 1) a discussion of competitive effects of the proposal among entities currently engaged in the activity;
  - 2) a statement of public benefits reasonably expected to result from the proposal; and
  - 3) a description of the terms and sources of funds for the transaction supported by the following:
    - (a) a copy of any pertinent purchase agreements;
    - (b) current financial statements for the company to be acquired;
    - (c) parent company only and consolidated pro forma balance sheets for the notificant as of the most recent quarter-end; and
    - (d) pro forma consolidated risk-based and leverage capital ratios for the notificant as of the most recent quarter-end.

Finally, for a bank holding company seeking to engage in an *unlisted* nonbanking activity, either on a de novo basis or through acquisition of a going concern, the notice must include two additional items:

- 1) evidence that the proposed activity is closely related to banking; and
- 2) a commitment to comply with all conditions and limitations that have been established by the board of directors governing the proposed activity.

If you have questions, please call Supervisory Officer Dennis Blase at (314) 444-8435.

## Board Streamlines Formation Procedures

The Community Development and Regulatory Improvement Act of 1994 (CDRIA) streamlined procedures for bank holding company formation transactions that are corporate reorganizations involving substantially the same shareholders. Effective September 23, 1994, a holding company formation proposal which meets the following criteria may be approved 30 days following written notice to the Reserve Bank and consummated immediately upon receipt of notice of approval.

- Shareholders who controlled at least 80 percent of the bank's shares, following the reorganization, control at least 80 percent of the holding company's shares in substantially the same proportion.

- The reorganization does not result in a change in control under the Change in Bank Control Act.
- The company demonstrates that any debt incurred in the transaction will not burden the company or its subsidiary bank.
- No nonbank activities result from the holding company formation.
- At its last examination, the bank received a 1 or 2 composite CAMEL rating.
- The bank is adequately capitalized under prompt corrective action guidelines.
- Neither the bank nor any of its officers, directors or shareholders is involved in any unresolved supervisory or enforcement matters with any federal banking agency.

Written notice for qualifying transactions must include the following five items:

- board of directors' certification that each of the seven notice criteria is met by the proposed transaction;
- shareholder lists for the bank and the holding company, showing ownership before and following the proposed reorganization;
- a description of resulting management of the proposed holding company and its bank, including biographical information for new senior officers or directors who were not senior officers or directors of the bank prior to the reorganization; detailed history of involvement of officers, directors or shareholders of the holding com-

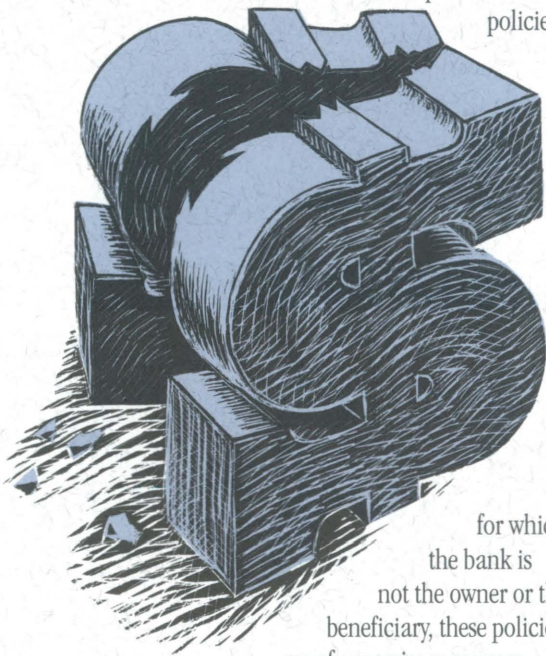
pany in any administrative or criminal proceeding;

- pro forma financial statements for the holding company; description including amount, source and terms of debt related to the transaction; financial projections showing debt service and retirement; and
- verification that notice of the formation, providing a 15-calendar day public comment period, has been published in a newspaper of general circulation in the bank's community.

Proposals that do not meet this criteria will continue to be subject to the regular applications procedures. If you have questions, please call Supervisory Officer Dennis Blase at (314) 444-8435.

# Examiners Review Large Dollar Life Insurance Policies

Recent examinations disclosed that some banks and bank holding companies have purchased large dollar life insurance policies on bank management officials. Many of these policies are structured as split-dollar insurance arrangements where different entities pay the premiums, own the policy and receive the death benefits. Because they normally obligate the bank to pay large premiums for policies



for which the bank is not the owner or the beneficiary, these policies are of supervisory concern.

## Examiner Evaluation

When evaluating a life insurance arrangement structured to compensate a bank official, examiners will focus on the following issues:

- 1) Was the compensation program reviewed and approved by the bank's board of directors?
- 2) Did the board:
  - determine the cost of the program either by

calculating the income lost by not investing in an asset that provides a market rate of return, or by calculating the bank's direct funding cost to pay and carry the accumulated premiums, including the cost of maintaining the cash value as an asset if it is capitalized on the bank's books;

- determine that the total compensation to the officer, including salary and other benefits, is comparable to compensation paid to a similar officer at a peer institution in the same region;
  - appropriately account for and report all payments as compensation on call and tax filings?
- 3) Are the earnings performance and capital position of the bank at or above peer averages?
  - 4) Do documents support the bank's right to receive death benefit proceeds equal to the bank's premium payments, plus interest?

## Supervisory Concerns

If capitalized, the resulting asset is subject to a review for quality based on the financial viability of the insurance company and underwriter. Non-earning assets are normally adversely classified or deducted for purposes of calculating capital.

If a subsidiary bank funds the purchase of a large dollar policy and the parent company is the primary beneficiary, the bank may violate the collateral requirements and possibly the

quantitative limitations of Section 23A of the Federal Reserve Act if the bank's premium payments are viewed as an unsecured extension of credit to an affiliate and that extension exceeds 10 percent of the bank's capital. The transaction may also violate provisions of Section 23B of the Act if the economic return derived by the bank for its lump sum payment is not commensurate with a market rate of return.

## Assessment Criteria

Because the purpose, structure and financial impact of each arrangement is unique; examiners will assess situations individually, considering:

- 1) the purpose of the arrangement and whether it represents a self-serving practice;
- 2) the size of the transaction and its effect on the financial stability of the institution;
- 3) whether the transaction complies with applicable banking laws and regulations; and
- 4) whether the bank or holding company asset is properly accounted for and accurately valued.

Examiners recognize that there are legitimate business reasons to carry life insurance on key management officials. Nevertheless, they will require that policies which disadvantage a supervised institution or threaten its financial stability be discontinued.

# Bankers' Comments Reshape CRA Small Institution Assessment Option

The September CRA proposal reflects the views of over 1,000 community bankers who commented to the Board of Governors on the small institution assessment option proposed last December. Over half criticized the proposed 60 percent loan-to-deposit ratio as a proxy for satisfactory CRA performance. In addition, community bankers expressed concern about the vagueness of other assessment criteria and wanted more certainty about examinations.

In response, the Board eliminated the 60 percent test and clarified the separate assessment standards for small banks. It also clarified that all small banks will receive a streamlined examination, unless the bank elects another assessment method. The current proposal retains the definition of a small bank as one with total assets less than \$250 million that is either independent or an affiliate of a holding company with total banking and thrift assets less than \$250 million. Approximately 819 Eighth District institutions qualify for this option.

## Delineation of Service Area

Each bank must define a service area which includes only whole census tracts or block numbering areas. In addition, it must include all areas equidistant from those branches and deposit-taking ATMs around which the bank has originated or had outstanding a significant

number and amount of home mortgage, small business and small farm loans.

## Assessment Standards

The small bank standards rely heavily on lending performance. To receive a satisfactory rating, a bank must demonstrate:

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### The Board has eliminated the 60 percent test and clarified assessment standards.

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- a reasonable loan-to-deposit ratio (considering seasonal variations) given the bank's size, condition and the credit needs of its service areas, taking into account other lending-related activities, such as loan originations for sale to secondary markets or community development lending or investment;
- that a majority of its loans and other lending-related activities are in its service area;
- a distribution of loans and other lending-related activities for individuals of different income levels (including low- and moderate-income individuals) and businesses and farms of different sizes that is reasonable given the demographics of its service area;

- a record of responding to written complaints about performance in meeting credit needs in its service area, and
- a reasonable geographic distribution of loans, given its service area.

Eligibility for an outstanding rating will include an evaluation of whether performance exceeds each of the standards for a satisfactory rating. It will also include the bank's performance in making qualified investments (as defined in the regulation) and its performance in providing branches, ATMs or other services and delivery systems that enhance credit availability in its service area.

## Assessment Context

A small bank's lending performance will be evaluated

in an assessment context that includes:

- demographic information on income levels, housing costs and other information regarding the credit needs in its service area;
- product offerings and business strategy;
- financial condition, the economic climate and other factors that affect its ability to lend;
- past performance and the performance of similarly situated lenders; and
- comments in the bank's public file and those submitted to the Reserve Bank following announcement of the examination schedule.



# BANK PERFORMANCE

## Strong Loan Growth Drives Changes in Assets and Funding

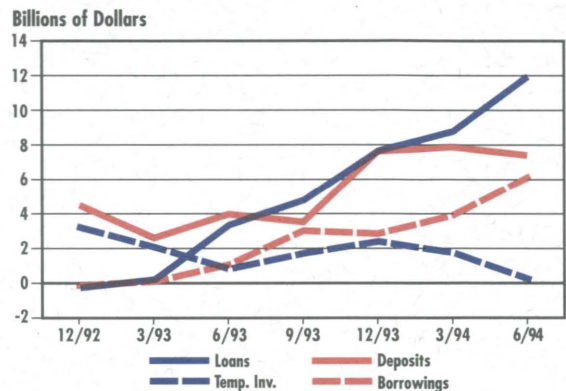
**E**ighth District loans grew at a consistent 9.5 percent annual rate from year-end 1992

through June 30, 1994, outpacing the 4.7 percent growth in total assets during the period. Lending activity has increased across all loan categories. The largest contributor is real estate-secured loans, which accounted for 54 percent of loan growth for the 12-month period ending June 30.

Consumer lending has also increased significantly, accounting for 26 percent of loan growth for the same period.

As of June 30, loans represented 58 percent of District banking assets. This compares with a low of 54.1 percent at year-end 1992 and nearly approaches the pre-recessionary

### 8th District Banks Cumulative Quarterly Growth



level of 58.2 percent as of September 30, 1990.

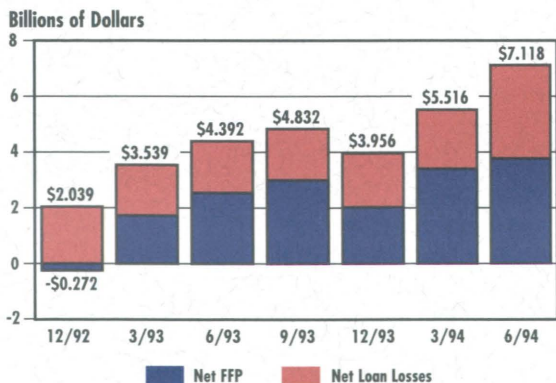
With loan growth exceeding asset growth, it might be expected that securities holdings would decline. To the contrary, District banks have increased their holdings by 5.2 percent since year-end 1992. Although the second quarter of this year reflected a slight drop in securities, the amount is not a significant factor in that quarter's increase in loan growth. Instead, most loan growth was offset by a reduction in temporary assets, principally federal funds sold.

On the liability side of the balance sheet, funding reflected a shift to short-term borrowings. While District deposits have grown a modest 2.3 percent since 1992, District bank balance sheets reflected significantly higher positions in purchased overnight funds

and short-term borrowings of less than one year. Indeed, since 1992 the District has been a net purchaser of federal funds and short-term borrowed funds have doubled.

All District peer groups, particularly banks with more than \$1 billion in assets, reported increases in interest-bearing funds and declines in core deposits relative to assets. The net loan-to-core deposits ratio for all District banks is now at 78.2 percent, up from 69.6 percent in 1992. District banks over \$1 billion reported net loans to core deposits at 84.2 percent as of June 30. Bank performance during the second half of 1994 will indicate whether this increased use of nondeposit funding sources will adversely affect net interest margins and liquidity, particularly with the recent rise in short-term rates.

### 8th District Banks Purchased Overnight Funds Position



# CDRIA Extends Safety and Soundness Examination Cycles

**B**ecause of the Community Development and Regulatory Improvement Act of 1994 (CDRIA), significantly more banks are eligible for an 18-month examination cycle. CDRIA expands the 18-month cycle to include all banks with total assets under \$100 million with a satisfactory rating. Also, banks with assets between \$100 and \$250 million with CAMEL ratings of 1 will now qualify for the extended examination cycle.

Based on current ratings, approximately 470 more District banks are eligible for the extended cycle under these new criteria.

The extended cycle will be phased in over the next year for newly eligible state member banks in alternate examination programs as the Reserve Bank works with state supervisors to adjust the 1995 schedule.

In addition, two years after enactment, CDRIA allows bank regulators to further expand the \$100 million

asset ceiling for satisfactory banks to \$175 million, expanding further the number of institutions whose cycles can be extended.

The statute requires federal supervisors to coordinate examinations with each other and with state supervisors. Within two years, the federal agencies must designate which agency will take the lead in coordinating unified examinations.

## Indebtedness Reports Due January 31

Executive officers and principal shareholders of member banks are required by Regulation O to annually disclose their indebtedness and the indebtedness of their related interests to the correspondent banks of the member bank. FFIEC Form 004 or a similar form must be submitted to the

board of directors by January 31, 1995. For copies of FFIEC Form 004, call Donna Rigdon at (314) 444-8437.

### 1993 HMDA Data

The 1993 HMDA data are now available for public inspection at a central depository in each MSA.

HMDA data are available in various formats (paper, magnetic tape, diskette, and CD-ROM). Order forms can be obtained by calling (202) 452-2016 and selecting option three. For information on the location of central depositories call Joyce Campbell at the FFIEC at (202) 634-6526.

### FFIEC Seminars

The FFIEC will conduct two Risk Management Planning seminars in 1995 for chief executive officers, directors and other executive officers of bank and thrift institutions.

- February 13-14, Orlando, FL
- May 16-17, Seattle, WA

For registration materials and further information, call Sarah Casanova at (314) 444-4634.



Post Office Box 442  
St. Louis, Missouri 63166

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