THE FEDERAL RESERVE BANK of ST. LOUIS

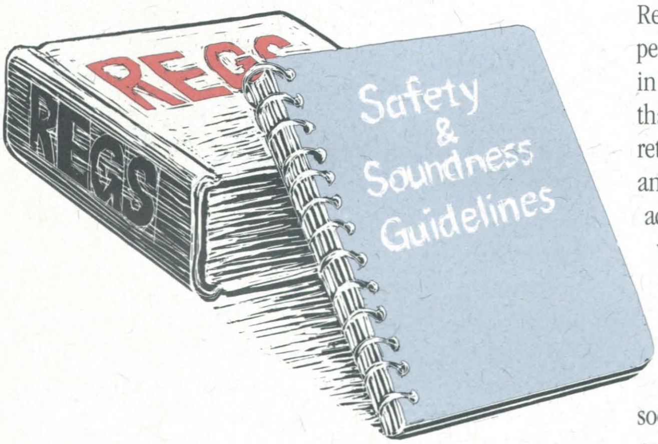
SUPERVISORY ISSUES

March 1995

Supervisory News and Views for the Eighth District

Fed Issues Safety and Soundness Guidelines

Reflecting recent legislation and comments from bankers, the safety and soundness standards mandated by FDICIA have been issued by the Fed and other banking agencies as guidelines rather than regulations. The guidelines, which apply to banks (but not bank holding companies) represent the standards now used by the agencies to assess the operational and managerial quality of an institution. As such, most guidelines closely follow the standards initially proposed and do not represent a change in policies or examination practices.



The proposed standard that generated the most comments was the requirement for an internal audit system. This standard was misinterpreted by many bankers as requiring a separate internal audit function. The guidelines clarify that the standard of independence and objectivity can be met by ensuring that the person conducting the review is independent from the function under review and is able to report findings directly to the board of directors or to a designated directors' audit committee.

While last year's Riegle Community Development and Regulatory Improvement Act permitted the standards to be in the form of guidelines rather than regulations, the agencies retain the authority to require an institution to submit an acceptable compliance plan as well as the ability to pursue more severe enforcement remedies where necessary.

For state member banks, the following guidelines will soon be sent to bankers as an appendix to Regulation H.

Operational and Managerial Standards

Internal Controls and Information Systems

An institution should have internal controls and information systems that are appropriate for the size of the institution and the nature and scope of its activities, and provide for:

1) an organizational structure that establishes clear lines of authority and responsibility for monitoring adherence to policies;
2) effective risk assessment;
3) timely and accurate financial, operational and regulatory reports;
4) adequate procedures to safeguard and manage assets; and
5) compliance with applicable laws and regulations.

Internal Audit System

The internal audit program should be appropriate for the size and complexity of the institution and provide for:

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Safety and Soundness Guidelines

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1) adequate monitoring of the system of internal controls. For an institution whose size, complexity or scope of operations does not warrant a full scale internal audit function, a system of independent reviews of key internal controls may be used;
2) independence and objectivity;
3) qualified persons;
4) adequate testing and review of information systems;
5) adequate documentation of tests and findings and any corrective actions;
6) verification and review of management actions to address material weaknesses; and
7) review by the institutions' audit committee or board of directors of the effectiveness of the internal audit systems.

Loan Documentation

An institution should establish and maintain loan documentation practices that:

1) enable the institution to make an informed lending decision and to assess risk, as necessary on an ongoing basis;
2) identify the purpose of a loan and the source of repayment, and assess the ability of the borrower to repay the indebtedness in a timely manner;
3) ensure that any claim against the borrower is legally enforceable (note that a legal opinion is not required);
4) demonstrate appropriate administration and monitoring of a loan; and
5) take account of the size and complexity of a loan.

Credit Underwriting

An institution should establish and maintain prudent underwriting practices that:

1) are commensurate with the types of loans the institution will make and consider the terms and conditions under which they will be made;
2) consider the nature of the markets in which the loans will be made;
3) provide for consideration, prior to credit commitment, of the borrower's overall financial condition and resources, the financial responsibility of any guarantor, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed;
4) establish a system of independent, ongoing credit review with appropriate communication to management and to the board of directors;
5) take adequate account of concentration of credit risk; and
6) are appropriate to the size of the institution and the nature and scope of its activities.

Interest Rate Exposure

An institution should:

1) manage interest rate risk in a manner that is appropriate to the size of the institution and the complexity of its assets and liabilities; and
2) provide for periodic reporting to management and the board of directors to assess the level of risk.

Asset Growth

Asset growth should be prudent and consider:

1) the source, volatility and use of the funds that support growth;
2) any increase in credit risk or interest rate risk as a result of growth; and
3) the effect of growth on the institution's capital.

Compensation, Fees and Benefits

An institution should maintain safeguards to prevent the payment of compensation, fees and benefits that are excessive or that could lead to material financial loss to the institution.

Prohibition on Compensation that Constitutes an Unsafe and Unsound Practice

Excessive Compensation

Excessive compensation is prohibited as an unsafe and unsound practice. Compensation shall be considered excessive when the amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director or principal shareholder, considering the following:

1) the combined value of all cash and non-cash benefits provided to the individual;
2) the compensation history of the individual and other individuals with comparable expertise at the institution;
3) the financial condition of the institution;
4) comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the loan portfolio or other assets;
5) for post-employment benefits, the projected total cost and benefit to the institution;
6) any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the institution; and
7) any other factors the Board determines to be relevant.

Compensation Leading to Material Financial Loss

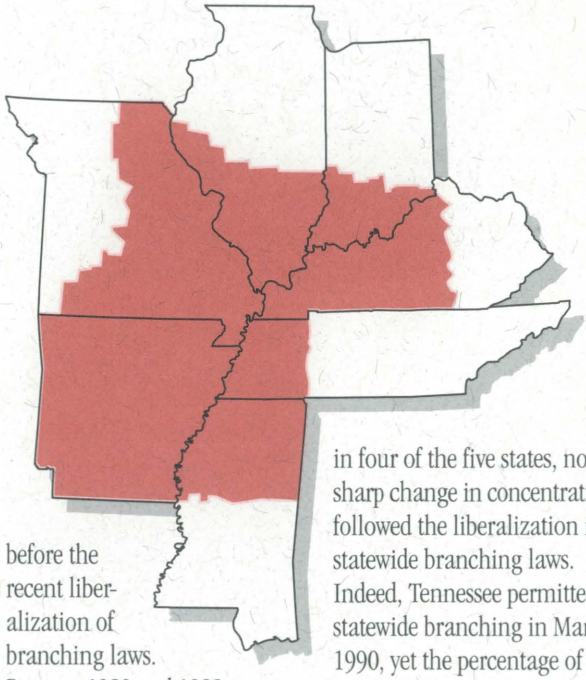
Compensation that could lead to material financial loss to a bank is prohibited as an unsafe and unsound practice.

Other Standards

The agencies did not prescribe a minimum ratio of common stock market value to book value, finding such a ratio to be infeasible.

The agencies have proposed for public comment that the ratio standards initially set for asset quality and earnings be replaced by monitoring and reporting systems to identify emerging problems and corrective actions to resolve them.

Bank Consolidation Increases in 8th District States



Over the four years between July 1989 and June 1993, five of the seven Eighth District states—Missouri, Mississippi, Illinois, Indiana, and Tennessee—relaxed prohibitions against statewide branching. Trends in these five states indicate that banking consolidation was well underway by 1994. One measure of consolidation is the percentage of state deposits controlled by the ten largest banking organizations. By this measure, banking concentration increased in these five states that liberalized branching laws. For example, in Indiana the largest ten banking organizations controlled 28.6 percent of statewide banking deposits in 1980. By 1993, the percentage had more than doubled to 60.4 percent. Even in Illinois, the Eighth District state exhibiting the smallest rise in concentration, the largest banking organizations increased market share from from 41.7 percent to 47.8 percent of statewide deposits over the fourteen-year span.

Most of the increase in concentration, however, occurred in the early and mid 1980s, before the recent liberalization of branching laws. Between 1980 and 1988, for example, the largest ten Mississippi banking organizations increased market share from 45.4 to 60.7 percent of statewide deposits. In contrast, the number rose by only 2.5 percentage points over the next six years. Though the largest Missouri banking organizations increased control of the state's total deposits from 54.4 percent in 1980 to 63.2 percent in 1988, these banking organizations added only 1.2 percentage points to market share in the following six years. Moreover, in four of the five states, no sharp change in concentration followed the liberalization in statewide branching laws. Indeed, Tennessee permitted statewide branching in March 1990, yet the percentage of statewide deposits controlled by the largest ten Tennessee banking organizations was actually lower in 1991 (67.2 percent) than in 1989 (69.1 percent). Only in Indiana did banking concentration increase dramatically. Following liberalization of branching laws in May 1991, the largest ten Indiana banking organizations increased market share from 52.9 to 61.7 percent of total deposits.

In short, bank consolidation in Eighth District states over the last fourteen years was independent of the relaxation in statewide branching rules. On the basis of this evidence, passage of the Riegle-Neal Interstate Banking and Branching Act may not accelerate the trend in the district.

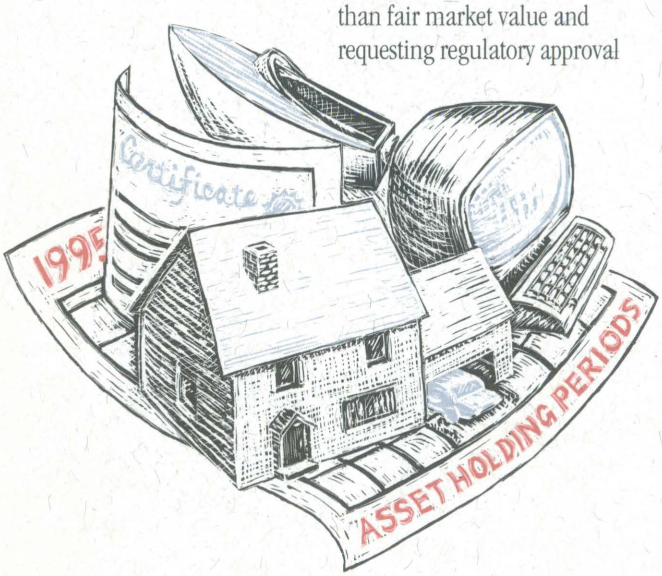
By Mark D. Vaughan, a Senior Manager in Supervisory Policy Analysis at the Federal Reserve Bank of St. Louis.

State By State Trends In District Bank Consolidation

	Concentration Ratio (Percentage of Deposits Controlled by the Largest 10 Banking Organizations)			Growth Rate	
State	1980	1989	1993	1980-1989	1989-1993
Arkansas	26.5	38.9	45.3	46.8%	16.4%
Illinois	41.7	44.5	47.8	6.7%	7.5%
Indiana	28.6	51.4	60.4	79.7%	17.5%
Kentucky	34.9	46.6	49.2	33.5%	5.6%
Mississippi	45.4	60.9	63.2	34.1%	3.7%
Missouri	54.4	62.7	64.4	15.3%	2.8%
Tennessee	51.3	69.1	66.7	34.7%	-3.5%

Limitations on Transfers and Holdings of DPC Assets

Recent inspections of District bank holding companies indicate that assets acquired in the process of collecting a debt previously contracted (DPC assets) are often transferred at other than fair market value and retained beyond the applicable holding period. In these instances, examiners will cite a violation of Regulation Y and ask that the company take corrective action which may include making reimbursement to the bank for transfers at less than fair market value and requesting regulatory approval for holding periods beyond two years. Following are guidelines for transferring and holding these assets.



Transfers of DPC Assets

Transfers or purchases of DPC assets *to or within* a holding company must be made at the fair market value of the asset at the time of the transfer and the transfer must be made on an arm's-length basis.

Holding Period

Under the Banking Holding Company Act and Section 225.22(c)(1) of Regulation Y, these assets may be acquired *without* regulatory approval if the DPC asset is divested within *two* years. The holding period begins when *any entity* within the organization acquires the asset. Transfers of DPC assets within the holding company do not extend, or begin anew, any period for required divestiture.

Extensions of the Holding Period

The Reserve Bank may, upon request, extend the holding period for up to a maximum of 10 years for real estate and five years for all other assets, provided requests are made before the holding period expires. Despite the extension, bank holding companies are expected to continually make good faith efforts to achieve divestiture.

If the initial two-year period has expired, examiners will look for evidence that this Reserve Bank has granted an extension to hold any DPC assets covering the current period. The examiners will also review documentation evidencing the transfer or purchase of the asset, supporting the carrying value and demonstrating efforts to dispose of the property. Since DPC assets are generally non-earning, they will usually be adversely classified as substandard. The amount of book value in excess of fair market value will be classified as loss.

Regulation O: Questions and Answers on Related Interests

"Insiders," as they are defined by Regulation O, consist of all executive officers, principal shareholders, and directors *and their related interests*. However, based on questions and inquiries received at this Reserve Bank, identifying a "related interest" is sometimes difficult. To apply both the individual and aggregate lending limits in Regulation O, banks must aggregate all extensions of credit to insiders *and their related interests*. The individual lending limit is generally the bank's legal lending limit to one borrower, while the aggregate lending limit for insiders as a class is 100 percent of the bank's equity capital and valuation reserves (200 percent in certain instances for small banks).

The following questions and answers clarify when an insider's relationship with another entity is a "related interest."

Do related interests include more than business corporations?

Yes, related interests include all corporations and partnerships, joint ventures and sole proprietorships controlled by

(continued on back page)

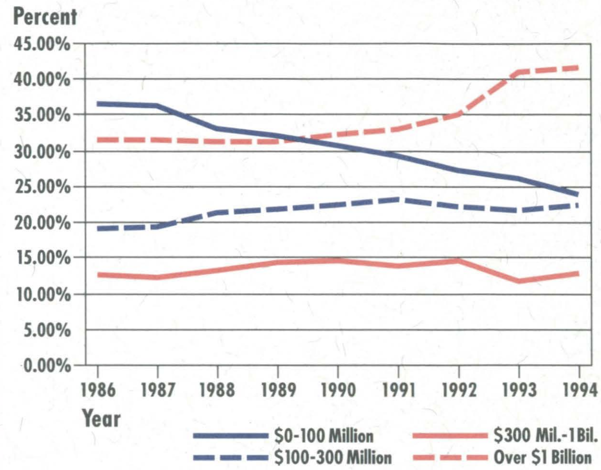
Bank Performance

Trends in District Concentration

The passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 has increased interest in industry consolidation. Recent trends indicate that larger institutions hold a greater percentage of banking assets. While this implies increased concentration, competition among the largest institutions may have also increased.

In the Eighth District, the number of commercial banks with assets less than $100 million dropped from 1,139 banks in 1986 to 858 banks in September 1994. As illustrated in Figure 1, most of this decline occurred at banks with assets of less than $50 million. Acquisitions accounted for the bulk of the decrease in the number of small banks, followed by asset growth and bank failures.

Figure 2: Percentage of District Assets by Asset Size



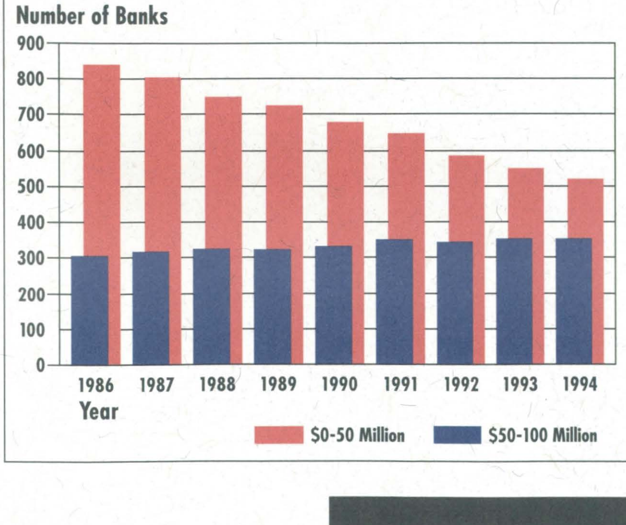
Not surprisingly, the percentage of assets held by banks with assets under $100 million has decreased as well—from 36.2 percent of total Eighth District assets in 1986 to 24.2 percent in September 1994. As shown in Figure 2, in the late 1980s, banks with assets of less than $100 million held a greater percentage of District assets than banks over $1 billion, a condition which has reversed in the 1990s.

In 1986, the District had 13 banks with over $1 billion in assets; these banks held 32 percent of District assets. In 1994, the 20 banks with over $1 billion in assets held 41 percent of District assets. While these data do not provide conclusive evidence of increased concentration, the trend is clearly toward larger banks. The other asset categories in Figure 2, in general, showed either minimal growth or slight declines over the decade.

While the assets controlled by large banks in the District has increased, concentration in the nation as a whole is much higher. From 1986 to 1994, assets of commercial banks over $1 billion grew from 67 percent to 74 percent of all U.S. banking assets. In short, even with geographic limitations, banks were able to consolidate. Whether branching across state lines will accelerate that trend, however, is an open question.

By Andrew P. Meyer, an Associate Economist in Supervisory Policy Analysis at the Federal Reserve Bank of St. Louis.

Figure 1: Number of Small District Banks by Asset Size



Regulation O: Q & A

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the insider. In addition, other entities such as trusts (business or otherwise), associations, or incorporated organizations, and political campaigns controlled by, or for the benefit of, executive officers, directors and principal shareholders are also related interests.

When does an insider *control* a related interest?

Definite control is established if the insider directly or indirectly (or acting in concert with others) meets any of the following three tests:

1) owns, controls or has power to vote 25 percent or more of *any* class of voting securities;
2) controls in any manner the election of a majority of the directors; or
3) has power to exercise controlling influence over management or policies of the company.

In addition, a presumption of control exists if an insider:

1) is an executive officer or director of a company and has 10 percent ownership; or
2) has 10 percent ownership and holds no other position in the company, but no other person has a higher ownership of that class of voting securities.

An insider may rebut a presumption of control by submitting written materials demonstrating an absence of control to the appropriate federal banking agency. If the agency agrees, then no control exists and the restrictions will not apply.

If a bank's director is the grantor or trustee of a trust, is the trust a related interest of the director?

Yes. If the director is a trustee of a trust or has power to sell or dispose of the assets, terminate the trust or replace the trustee, the director is considered to control the trust.

What if the insider is only the beneficiary of a trust?

The trust would not be a related interest. However, if the insider is a beneficiary of the trust and his or her interest is 25 percent or more, then a loan to the trust would be considered to be made for the benefit of the insider and counted as part of the lending limit applicable to the insider.

Would borrowings by an insider-controlled trust be included in determining a bank's compliance with the "individual lending limit" and "aggregate lending limit"?

Yes. If the trust were considered a related interest of the insider, its borrowings would be considered a loan to the insider. Which would be included in determining compliance with these limitations.

Our director owns 30 percent of company A, which in turn owns 30 percent of company B. Is company B considered to be a related interest of our director?

Yes. A person is considered to control any company he or she directly or indirectly owns, controls, or has power to vote 25 percent or more of any class of voting securities.

Do the additional restrictions on loans to executive officers, generally $100,000, also extend to executive officers' related interests?

No, although they may apply to certain partnerships of which the executive officer is a member.

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