THE FEDERAL RESERVE BANK of ST. LOUIS

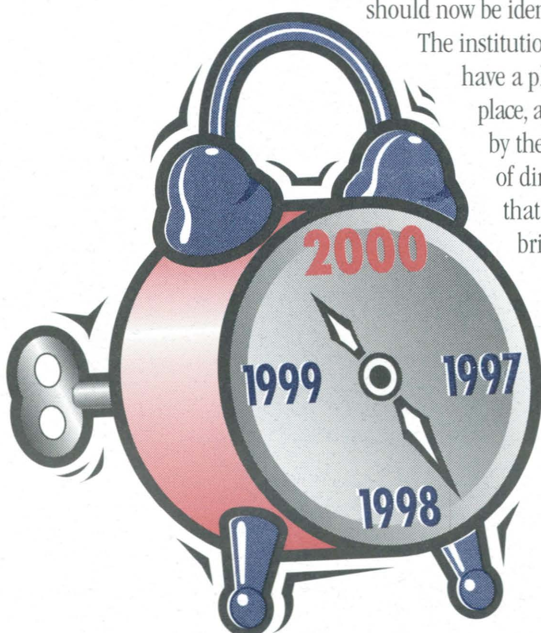
SUPERVISORY ISSUES

Autumn 1997

Supervisory News and Views for the Eighth District

Year 2000: Continue Progress

Community banks have a number of challenges ahead of them to prepare for the century date change. As of Sept. 30, 1997, all institutions should have completed the awareness and assessment phases of the Year 2000 preparedness project. The Year 2000 readiness of all critical computer hardware, software applications, interfaces between systems and data interchange points with external sources should now be identified. The institution must have a plan in place, approved by the board of directors, that will bring these items into Year 2000 compliance. It is very important for the board of directors to remain involved with the Year 2000 issues, since it is the directors' ultimate responsibility to make sure their bank will operate properly after the century date change.



Renovation Phase

During the next phase of the project—the renovation phase—banks must make actual changes necessary to bring their systems into Year 2000 compliance. Community banks with in-house systems are relying on software vendors to make changes on the banks' critical applications. Banks that have outsourced the data processing function are depending on their service provider to provide Year 2000 compatible processing of their bank records. With this reliance comes several important responsibilities:

1. Monitor the software vendor or data processing servicer activities to make sure the vendor or servicer is meeting acceptable time frames for renovation and testing.

2. Monitor changes by multiple vendors to assure that data interchanges between these systems handle Year 2000 changes consistently. For example, while a vendor might make a particular software platform Year 2000 compliant, it must then interface with revised software applications from other software vendors and outside servicer providers (such as ATM processors).

3. Assure that any programs developed by contract programmers retained by the bank are reviewed and modified to bring them into compliance. If the contract programmer is no longer accessible and unable to provide a Year 2000 status for any such programs that are critical, then renovation will be more complicated and perhaps a costly endeavor.

4. Upgrade and/or replace all hardware, including personal computers, that are determined not to be Year 2000 compliant.

Code enhancements and revisions, hardware upgrades, and other associated changes that compose the renovation phase

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Year 2000

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should largely be completed by Dec. 31, 1998.

Validation Phase

Once a bank's critical systems have been renovated, they must be tested and verified. Larger institutions with a programming function can purchase software tools specifically designed to test Year 2000 applications by simulating a Year 2000 operating environment. However, most community banks running turnkey banking application packages are not technically adept at developing a formal testing plan for vendor modified program changes. Proper testing of applications generally requires resetting the computer system date past the Year 2000 before the applications are run. In certain situations, resetting the system date could cause significant problems, including deletion of critical data files. Many Year 2000 consultants strongly discourage resetting the date on production computers.

Banks will have to work with each of their vendors to determine the method and amount of testing that will need to be performed at the individual bank level. Some vendors plan to fully test their Year 2000 program updates at the development site and also test the changes at a select number of individual bank sites with different hardware configurations. Banks that do not have one of these tested hardware platforms might be required to conduct their own full in-house test. It also is possible that some vendors will require a full in-house test conducted at all their client banks.

Software vendors and data processing servicers should develop an all-inclusive testing plan that addresses their own internal testing and describes the methodology and extent needed for testing in the client banks. Testing of interfaces and exchange of data between different vendors' software products and payment system providers should be a high priority. From their vendors, banks should receive detailed testing instructions specifying testing methods, data, and expected results. Proper testing procedures assure banks that all their systems will interface and be compatible with the Year 2000 date changeover. Testing and verification of systems is expected to be an involved and lengthy process and should be well under way by Dec. 31, 1998.

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Review of Loan Customers

Banks should consider Year 2000 issues facing their loan customers and incorporate these issues in their underwriting standards. For instance, a corporate customer may experience financial difficulties resulting from disruptions to its business caused by the failure of its computer systems to perform at the century date turnover. Depending on the nature and extent of the disruption to the business, repayment risk may increase. Likewise, a bank's loan review process and its methodology for evaluating the adequacy of the loan loss reserve should consider Year 2000 issues.

Develop a Contingency Plan

A contingency plan should be developed if it appears that a vendor or servicer will not be able to meet a reasonable deadline in providing Year 2000 compatible software to the bank. Current renovation and testing progress of vendors or service providers should be evaluated far enough in advance to allow for a possible conversion to another software package, banking application system, or servicer. In many cases, the lead time required to convert a bank to a new system could be a significant number of months.

Many bankers are finding that the Year 2000 preparedness project is requiring more personnel and taking longer than originally projected. Therefore, we strongly encourage bank directors and management to closely monitor the sufficiency of resources and make adjustments where needed to successfully complete the project.

By Jeffrey L. Schneider, a Supervisory Examiner at the Federal Reserve Bank of St. Louis.

Reminder

Effective with the Dec. 31, 1997, report date, banks with assets less than $50 million will be required to file their Call Reports electronically or on computer diskette with EDS (the federal bank supervisors' collection agent). Banks may opt to contract EDS or any other party to convert their paper-based Call Report to an automated format for electronic filing.

The requirement for electronic filing was made effective with the Sept. 30, 1997, report, date for all other size banks.

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What Does Risk-Focused Supervision Mean for Eighth District Bankers?

Our risk-focused supervision program is now in place and being used for all state member bank examinations and bank holding company inspections. There are six defined categories of risk in a financial institution—credit, liquidity, market, operational, legal and reputational risks—that examiners will evaluate as part of every assignment. These risks, and the bank's ability to effectively manage them, are the basis for carrying out supervision of an institution. By conducting risk-based reviews, examiners are able to reduce time spent in low risk activities and emphasize those areas with potentially emerging problems.

Planning for Risk Focused Exams

Pre-examination planning is the essential first step in our risk-focused supervision program. Approximately two months before the beginning of an examination, the examiner-in-charge prepares a preliminary risk assessment of the institution by evaluating available regulatory documents and then contacting the banker to cover other pertinent information. Areas of focus would include expansion or elimination of business lines/products, new strategic initiatives, significant revisions of policy and procedures, audit and loan review findings, changes in key management personnel and responsibilities, and financial plans. The risk assessment highlights both the strengths and vulnerabilities of an institution and provides the basis from which examiners will set the scope and select procedures to be used during an on-site examination or inspection.

Tailored Examination and Inspection Scopes

We expect that risk-focused supervision will eliminate the necessity for performing the traditional comprehensive full-scope examination or inspection for most supervised banking institutions. Our letter to you announcing the scheduling of an examination/inspection should no longer include a standardized "Examiner's Questionnaire" and request for documents. This letter will now be customized to reflect the tailored scope and activities to be reviewed.

Examiners may conclude that certain aspects of the examination, such as a review of the securities portfolio, can be performed off-site. In limited situations, such as small shell bank holding companies, the supervision may be conducted entirely off-site.

On-site Activities Will Focus on Risk Management Processes

During the on-site examination or inspection, bankers will generally find that examiners will focus more of their attention on assessing risk management processes and less on transaction testing. Past supervision practices have relied heavily on transaction testing as a means to determine the financial and operating condition of banking institutions; however, such testing by itself is no longer sufficient for assuring the continued safe and sound operation of financial institutions in today's highly dynamic banking market. Our four principles for sound risk management consist of effective board and senior management oversight; policies, procedures and limits; risk measurement, monitoring and information systems; and internal controls.

The quantity of risk an institution undertakes in conjunction with the quality of its risk management processes will largely dictate the amount of transaction testing to be performed. For instance, if the institution's risk management of lending activities and accounts is found to be effective, examiners may elect to rely more heavily on an institution's

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Risk-Focus

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internal loan review results and reduce the number of credit files reviewed. However, when risk management processes are found to be lacking, sufficient additional transaction testing may be performed to assess that area. This is not to imply that institutions are expected to develop low-risk profiles, but rather to assure that risk management processes are commensurate with the risk profile.

Reporting of Risk and Risk Management Assessments

Examiners will discuss their final assessment of the institution's level of risk in each of the six defined risk categories at exit meetings with management and the board, and present these findings in the Reports of Examination and Inspection. Likewise, examiners will also focus on overall conclusions regarding the adequacy of risk management processes and highlight any areas that need improvement.

Risk-focused supervision will provide needed flexibility in the supervisory process, thereby enhancing the efficiency and effectiveness of bank and bank holding company supervision. We are seeking to achieve an optimal mix of risk management process review and transaction testing in areas of the institution with the greatest risk. In the end, the likely by-product of the risk-focused approach is a win-win situation where most bankers will see their examiners less and their customers more.

By Herman H. Buergler, Jr. and Gary S. Corner, both Supervisory Examiners at the Federal Reserve Bank of St. Louis.

CRA Data Reporting Tips

Based on the experience gained from the first year of CRA data collection, following are some tips to help avoid errors when reporting your 1997 CRA data, due March 2, 1998.

Small-business and Small-farm Loan Data

CRA uses the Call Report definitions for small business and small farm loans for purposes of determining which loans must be reported under the regulation. Accordingly, any business loan that is less than or equal to $1 million at origination or purchase and any farm loan less than or equal to $500 thousand are reportable under CRA.

Neither the asset nor revenue size of the business or farm is relevant in determining which loans to report; only the loan amount.

Consumer Loan Data

While institutions may opt to collect and maintain consumer loan data for consideration under the lending test, this information should not be reported to the Federal Reserve. Only small-business, small-farm, and community development loans are required to be reported. Examiners will review the consumer loan data when examining the institution for CRA.

Assessment Area Data

In addition to loan data, institutions are required to report their defined assessment area(s). The assessment area(s) need not include every geography where the institution has made a loan. Generally, the assessment area delineation(s) should include the geographies where the bank makes the majority of its loans. The regulation requires, however, that the assessment area include, at a minimum, each geography where the institution has its main office, branches and deposit-taking ATMs.

The FFIEC's interagency questions-and-answers document may be helpful in answering other questions concerning CRA reporting requirements. Contact your federal agency for a copy.

The FFIEC will distribute the next release of the CRA Data Entry Software (Version 1.10) in early December. Bankers may call the CRA assistance line (202-872-7584) or e-mail crahelp@frb.gov for assistance with CRA data entry.

By Robert T. Dowling, an Automation Specialist at The Federal Reserve Bank of St. Louis.

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Practices Leading to Issues in Fair Lending

Fair lending continues to be an important area of focus for the four federal banking regulators and the Department of Justice. In fact, interagency procedures are presently being developed and tested to maintain emphasis on this area, as well as bring about greater uniformity in agency practices. The Federal Reserve itself has committed a substantial portion of its examination resources to address fair lending issues. This article addresses three issues frequently encountered, which may result in violations of the Equal Credit Opportunity Act, implemented by Regulation B, and the Fair Housing Act. These practices may also expose the bank to litigation or prevent it from asserting an effective defense against such litigation. While the issues may require more formalized attention in large banks, they also arise in small community banks. A bank's board of directors should assess its level of fair lending risk and tailor its fair lending program appropriately, taking into consideration factors such as the size of the bank, centralization of its lending activities, complexity of its loan products and the demographics of its community. The article also discusses the role of a second review program in achieving an effective fair lending program.

Underwriting and Pricing Guidelines

One of the most important areas that can raise fair lending issues is a bank's underwriting and pricing guidelines. Failure to apply these guidelines uniformly to all applicants may result in unintentional disparate treatment on a prohibited basis. A bank should ensure it has adopted objective loan underwriting guidelines that are applied uniformly to all applicants for credit. This will help to ensure that marginal applicants with similar credit histories are treated consistently by different loan officers. While the guidelines need not be written, all lending personnel should fully understand them. Larger institutions with numerous loan officers and lending locations generally find it necessary to formalize the guidelines to ensure consistency. Small community banks may find that periodic discussions among lending personnel or other measures may be sufficient to ensure consistency.

The existence of underwriting guidelines should not preclude lending personnel from making underwriting exceptions. Such exceptions, however, should be applied uniformly, without regard to a prohibited basis. For instance, if a bank waives its requirement that credit reports contain no recent derogatories for a male applicant with medical derogatories, it should also waive the requirement for female applicants with the same credit problem.

Disparate treatment can also occur in a bank's loan pricing. While a bank's pricing structure need not be written, it should be objective enough that loan officers can offer applicants with similar credit qualifications the same interest rates and other loan terms. At the same time, the bank's pricing structure can retain the flexibility to consider factors such as credit risk and collateral type and value. As with underwriting guidelines, the extent to which a bank will need to formalize its pricing structure will depend upon its degree of fair lending risk. Large institutions with numerous lending officers, multiple products and complex pricing may find that risk is best managed by publishing rate sheets. Small community banks with little variation in pricing may find that informal discussions among loan officers are sufficient. One particular area of concern relating to pricing is the practice of overaging, which is discussed below.

Dealer Overaging Practices

Credit pricing inconsistencies have also been noted in the use of overaging. A bank may employ overaging as a vehicle to compensate dealers/brokers for the work completed during the loan origination process. Typically, the bank will set a base rate and allow the dealer/broker to determine the overage percentage, or the percentage points charged over the base rate. Fair lending issues may arise when the overage percentages vary between applicants if the variance is based on a prohibited basis.

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Fair Lending

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An example would be when all applicants under age 25 are assessed a 4 percent overage while all applicants above age 25 are assessed only a 2 percent overage. For those banks that utilize dealers/brokers and participate in the underwriting decision, management needs to monitor the overages charged to ensure that no consumer or group of consumers is disadvantaged on a prohibited basis.

Level of Assistance

Fair lending issues can arise when bank personnel fail to offer and provide comparable help to all loan applicants. For example, nonminorities receive more assistance than minorities in qualifying for a loan. Assistance may include requesting explanations for derogatory credit, rendering advice about structuring income and assets, or selectively offering alternative loan programs.

To ensure a level playing field, banks should take care to treat all applicants consistently. Bank staff should request the same information from and offer the same opportunities to each applicant to explain delinquent accounts, for example. Similarly, if the bank's loan policy requires self-employed applicants to provide tax returns from the previous three years, then three years of tax returns should be requested from all self-employed applicants.

The Second Review Process

The second review process is a widespread business practice that deserves special mention. The fair lending laws and regulations do not require that a bank implement a second review program but many banks have found it helpful in ensuring an effective fair lending function.

The rationale for a second review process is two-fold: First, it ensures that all creditworthy applicants are approved for loans; and second, it helps to ensure that all lending personnel apply loan policies consistently. If a bank decides to implement a second review program, the nature and scope of the program can be based upon the size of the bank and the extent of its fair lending risk. This may include performing a matched pair analysis between a targeted sample of denied and approved applications, as well as between a sample of approved applications. Areas of concern include inconsistent interest rates and terms, inconsistent underwriting criteria such as debt-to-income ratios, and unequal application of fee and appraisal requirements. The second review process is most effectively accomplished by a committee whose members are knowledgeable about the institution's credit practices.

> ...the fair lending program contributes to the overall financial soundness of the bank because all creditworthy applicants receive loans, while uncreditworthy applicants are rejected for credit.

The board of directors of each institution has the responsibility for ensuring that the bank is in compliance with the fair lending laws and regulations. After assessing the fair lending risk at its institution, the board should develop a fair lending program. An effective program serves to augment the underwriting process by challenging the bank to seek reliable indices of creditworthiness that are applied consistently for all applicants. It then compels the bank to implement underwriting criteria in an evenhanded and consistent manner. Finally, the fair lending program contributes to the overall financial soundness of the bank because all creditworthy applicants receive loans, while uncreditworthy applicants are rejected for credit.

By Mark E. White, a Consumer Affairs Examiner at the Federal Reserve Bank of St. Louis.

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BANK PERFORMANCE

Why are District Banks Losing the ROA Race?

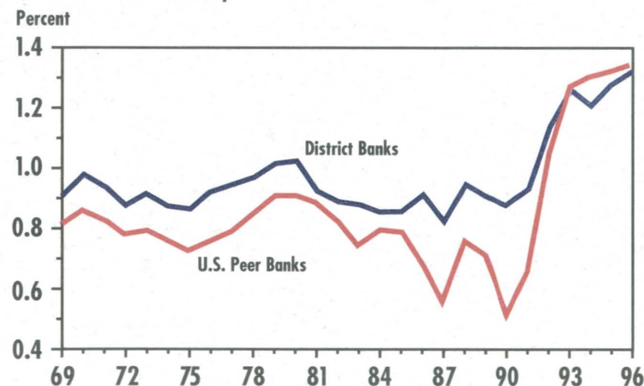
Last year, U.S. peer banks posted a return on average assets (ROA) of 1.35 percent—the highest figure in more than 30 years. Eighth District banks also posted a record ROA for 1996 of 1.33 percent. Although both groups of banks enjoyed record profits in recent years, U.S. peer banks have performed relatively better and are now recording a higher average ROA than District banks. The recent trend in overhead expense explains the reversal in the long-standing relationship between peer and District bank ROA.

District banks have historically posted a higher average ROA than U.S. peer banks. During the last ten years peer bank ROA averaged 0.95 percent, while District bank ROA averaged 1.07 percent. Although peer banks consistently reported a significantly stronger net interest margin, District banks always managed to record a higher average ROA. Traditionally, lower net noninterest expense and loan loss provisions more than compensated for the District's weaker margin.

The earnings advantage historically enjoyed by District banks ended in 1993. Between 1992 and 1996, District bank ROA improved 19 basis points to 1.33 percent, trailing the 30 basis point improvement in the peer bank ROA to 1.35 percent. The District's 8 basis point advantage in 1992 dissolved into a 2 basis point disadvantage.

A shrinking gap between District and peer bank net noninterest expense explains why peer banks are now outperforming District banks. In 1992, District banks posted a net noninterest expense ratio 17 basis points below that of peer banks. By 1996, the gap had narrowed to only 2 basis points as District banks experienced increases in overhead expense. Since 1992, peer banks have reduced other noninterest expense by 6 basis points and personnel and occupancy expense each by 3 basis points. Conversely, District banks reported increases of 5 basis points in both other noninterest expense and personnel expense, with no change in occupancy expense.

The robust Midwest economy is the most likely cause of the difference in personnel expense trends. In 1996, the average unemployment rate for the District's four largest MSAs was well below the national average of 5.4 percent, highlighting the District's tight labor markets. Between 1992 and 1996, average wages and benefits at District banks rose 21.5 percent to $35,449, in comparison to a 14.4 percent increase at peer banks to $37,787.



SOURCE: FFIEC Reports of Condition and Income for All Insured U.S. Commercial Banks, 1969-96

NOTE: Return on average assets (ROA) equals net income divided by average assets. U.S. peer banks consist of all U.S. commercial banks with assets less than $15 billion

The ongoing consolidation in U.S. banking probably explains relative movements in occupancy expense. Throughout the country, banks are merging and closing redundant offices to realize cost savings. For example, the number of U.S. peer banks dropped 16.7 percent from 11,290 in 1992 to 9,402 in 1996. The number of District banks also decreased from 1,194 to 1,036, or 13.2 percent. The faster pace of consolidation outside the District suggests that peer banks have been able to close more offices and, hence, trim more occupancy expense.

Second quarter 1997 numbers offer little evidence that the traditional relationship between peer and District ROA is re-emerging. Peer banks enjoyed an annualized ROA of 1.34 percent, 1 basis point above the District ROA of 1.33 percent. Given the continuing strength of the Midwestern economy and the faster pace of consolidation outside the District, it may take some time for District banks to overtake peer banks in the ROA race.

By Mark D. Vaughan an Economist and Senior Manager, and Andrew P. Meyer, an Economist at the Federal Reserve Bank of St. Louis. Thomas B. King and Thomas A. Pollmann provided research assistance.

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Find the Fed on the Internet

Bankers can find Federal Reserve System information on the Internet at www.bog.frb.fed.us. Available web sites provide quick and easy access to information on the central bank's activities. The main web site serves as an index to the various web sites available, including sites for:

Federal Open Market Committee (FOMC)

FOMC web sites provide information on scheduled meeting dates, committee membership and meeting minutes. Access to the Beige Book is also available.

Testimony and Speeches

Bankers can read the semi-annual Humphrey-Hawkins Testimony on monetary policy by Chairman Greenspan, as well as other testimonies and speeches given by Board officials.

Press Releases

This site allows users to view recent press releases issued by the Board, including requests for comments on amending regulations and Board approvals of applications and notices by bank holding companies and member banks.

Regulation and Supervision

Regulation and Supervision web sites include: enforcement actions placed against financial institutions supervised by the Federal Reserve; SR letters issued since January 1990; legal interpretations issued by Board legal staff; Year 2000 supervisory activities; general information on interstate branching; a summary of Federal Reserve regulations; and the weekly H.2A report of applications received by the Federal Reserve Banks.

Community Reinvestment Act

CRA ratings, designations, strategic plans and exam schedules of member banks are all available online.

Related Web Sites

Lastly, the central bank's main web site can guide you to the web sites of the individual Reserve Banks, the Federal Reserve's National Information Center (NIC), the FDIC, the FFIEC, the U.S. Department of the Treasury, and certain foreign central banks.

The Board of Governors has also made available online the various reports made by it to Congress, certain Federal Reserve Publications, and domestic and international financial data and surveys. Web site comments can be forwarded to the Board of Governors via the feedback form located at the main web site.

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St. Louis, Missouri 63166

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