MID-CONTINENT BANKER

FEATURES

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MID-AMERICA'S BANKING PUBLICATION

BANKING WIRE

MID-CONTINENT BANKER

November, 1986

Late-Breaking News From the World of Banking

CONCERNS VOICED AT ABA CONVENTION. Care should be taken when details of closing the nonbank loophole are formulated, said Randall A. Killibrew, president, First National, Petersburg, Ill. He warned that outside competitors with a foothold in the industry might be allowed to remain in business while bankers are prevented from competing with these competitors in their own markets. Joseph Pinola, chairman/CEO, First Interstate Bancorp, Los Angeles, challenged ABA Executive Vice President Donald G. Ogilvie to do more to bring the ABA, the Independent Bankers Association of America and the Association of Reserve City Bankers together when formulating banking legislation. Mr. Ogilvie responded by stating that preliminary steps in this direction have been taken. He claimed the industry is more united than ever.

INTERSTATE BANKING A MOOT ISSUE? ABA Executive Vice President Donald G. Ogilvie stated at the ABA convention that greater unity in the banking industry has resulted from resolution of the interstate-banking question. He said that rapid change at the state level has made interstate banking a moot issue. He was referring to the numerous regional banking compacts that have come into being during the past two years. "We've cleared the deck of some major problems and now we're ready to move forward," Mr. Ogilvie said.

ABA ELECTS DIRECTORS. New members of the ABA's board are Hans H. Angermueller, vice chairman, Citibank, New York; Charles D. Brummel, president, Security Bank, Coos Bay, Ore.; Hugh M. Chapman, president, C&S Corp., Atlanta; Thomas J. Stanton Jr., chairman/CEO, First Jersey National Corp., Jersey City, N.J.; Robert L. Stevens, president, Bryn Mawr (Pa.) Trust; and Alan R. Tubbs, president, First Central State, DeWitt, Ia. In addition, Richard L. Thomas, president, First National, Chicago, was appointed to complete the unexpired term of Charles Pistor, chairman/CEO, RepublicBank, Dallas, who was elected ABA president-elect.

CAIRNS JOINS BOARD OF CONSULTANT. James G. Cairns has joined the board of Furash & Co., Washington, D. C., financial-institution consulting firm. He provides management and regulatory consulting to troubled financial institutions and develops new consulting activities for Furash. He recently resigned as chairman/president/CEO, First Interstate, Oklahoma City.

JOE MERMIS TO RETIRE. J. A. Mermis Jr. plans to retire from Security State,

Turn to Reader Response Page (following page 48)

Great Bend, Kan. at year-end. He has been CEO since the bank's founding in 1950 and will remain an advisory director.

AN AWARD FOR CONSUMER-CREDIT RESEARCH will be given next fall by the Credit Research Center located at the Krannert School of Management at Purdue University, West Lafayette, Ind. Eligibility for the $1,500 award is dependent on a completed research paper on a consumer-credit or markets topic by next April 1. Appropriate topics include personal bankruptcy, private contracting, securitization, consumer behavior with regard to credit use, the relationship between consumer credit and the economy and related topics. Information is available by calling 317/494-4380.

FIRST COMPLIANCE, COUNSEL AND AUDITORS CONFERENCE ANNOUNCED. The ABA's first National Conference for Compliance Managers, Bank Counsel and Auditors will be held Sept. 23-26, 1987, in Crystal City, Va. The conference will deal with concerns about mergers and acquisitions, increases in bank fraud and other changes resulting from deregulation. An objective will be to examine how banks can control losses from potential risks such as insider abuse, which exceeded $800 million last year.

FED BROADENS LIST OF PERMISSIBLE INSURANCE ACTIVITIES. To act as a general insurance agent in a town of less than 5,000 population, a bank HC with less than $50 million in assets need no longer be headquartered in the community, but must only maintain a lending office there. Such HCs also can engage in any insurance-agency activity except sale of life insurance or annuities. These changes, as well as others, became effective Nov. 7.

LOUISIANA'S FIRST STATEWIDE BANK FORMED. Hibernia Corp., headquartered in New Orleans, has merged its five affiliate banks in the state into one statewide institution called Hibernia National Bank. The bank has combined assets of more than $4 billion and is said to be the first bank in the state to go statewide since enabling legislation was passed. Consolidation is expected to be complete by January 1.

HIRING OF HIGH-LEVEL BANKING EXECUTIVES SURGES IN THIRD QUARTER. The percentage of national executive hiring in financial services rose from 19% in the third quarter of 1985 to 27% for the same quarter in 1986, according to Korn/Ferry International, executive-search firm. Much of the activity is in large commercial banks making transitions from traditional lending to fee-generating services, a spokesman said. Commercial banks are recruiting Wall Street professionals in the trading, corporate-finance, mergers-and-acquisitions and leveraged-buyouts areas.

JOSEPH CRITT MURPHY has joined Central Bank, Lexington, Ky., as vice president/director of correspondent banking. He formerly was with Plansmith Corp., Palatine, Ill., and has been with two Kentucky banks.

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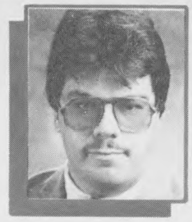


Questions of Efficiency

Securitizing bank assets will make for more efficient capital transfers, but since banks aren't playing the game on equal footing, will their position as key financial intermediaries continue to erode to the point they become mere loan brokers?

"ULTIMATELY, there's not much that commercial banks do in lending that can't be done more efficiently through securities markets," an investment banker told us recently. "Commercial banks need a 200- to 250-basis-point spread to make a profit while we can do extremely well at 45 basis points."

That difference in profit margin is a reflection of how efficiently securities markets move capital from people who have excess liquidity to those who need to borrow, our friend said. His point was that commercial banks pay a high price for the inefficiencies in their distribution system. He might also have added that commercial banks pay a high price for the regulation that prevents them from underwriting and trading in securities.

Although banks are learning to play the securitization game, they still find themselves at a severe cost disadvantage in relation to their less-regulated brethren in the financial industry. With each passing day, their roles as key financial intermediaries are eroded by nonregulated competitors with easier access to capital markets and without the costs of deposit insurance, reserve requirements, growing capital requirements, branch-system overhead and so on. Large corporate borrowers learned how to bypass the banking industry to meet their capital needs years ago and other borrowers now are taking a more direct route to capital markets as well.

With 50% of the nation's debt already securitized and the possibility that the total may increase to 80% within a decade, traditional lending institutions (banks, thrifts) may find themselves reduced to the role of brokers (loan originators), Lowell Bryan wrote in an article in the *Wall Street Journal* last month. Other entities may structure the securities, enhance credits, make trades and do most of the investing, he suggests. Mr. Bryan is a director of McKinsey & Co., New York, which is working with the American Bankers Association (ABA) and Robert Morris Associates (RMA) on a study of various facets of the bank-asset-securitization issue.

The implications of that shift in economic function are enormous, and while Mr. Bryan presents no firm conclusions, some of the issues he raises are troubling. The movement of assets off the balance sheets of the nation's traditional lenders and into securitized credits represents a shift in credit risk from banks and thrifts onto the guarantor and holder of each issue. Will banks and thrifts continue to perform their roles as watchdogs of credit quality if they no longer bear the bulk of the credit risk?

Some would say banks haven't performed very well as watchdogs of credit quality anyway and that the task is better left to security-rating agencies and investors in the securities markets. So far, the assets that have been securitized — home mortgages, student loans, car and small-truck loans, computer leases, SBA loans and credit-card receivables — are relatively homogenous with known credit risks and maturities. Underpinning those loan pools, however, is a cadre of good loan officers in banks and/or thrifts who decide to make the original loans based on the credit worthiness of the borrower.

What happens when those loan officers come to understand that their new role is to serve as salesmen for loans the institution plans to resell later? Regulators are concerned about such developments and, true to their nature, are proposing to tighten the screws at the point of origin. The Financial Accounting Standards Board is promulgating new standards for controling off-balance sheet activities of financial institutions, for example, the ultimate effect of which will be to promote better public disclosure of such activities. The Comptroller of the Currency has tightened banking requirements for investing in mortgage-backed securities.

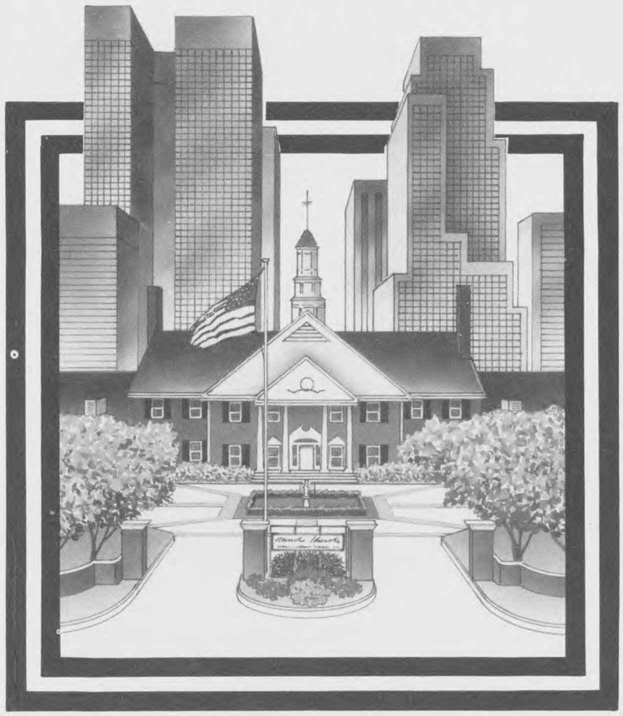
Anything that promotes better standards of credit management and protection of investors in debt securities probably is beneficial for the banking industry and the economy as a whole. Unfortunately, any plumber can tell you what will happen when you tighten the pressure in one part of a system and don't do it elsewhere. Higher yield, lower-risk assets will flow toward the less-regulated players in financial markets, leaving commercial banks with the less-attractive assets in their loan portfolios and for use as the base for debt securities. If regulators have their way, banks also will be more restricted in participating freely in the debt-securities game as investors.

In an ideal world, banks hardly could fail to benefit from becoming more active in the securities markets, both as issuers and purchasers of debt securities. Their loan portfolios would be more liquid and the new instruments created would provide greater opportunities for portfolio diversification. Risk would be spread more evenly throughout the banking system and greater stability should result. This is precisely the logic the ABA has used in calling for creation of a market in securities backed by ag loans.

Alas, the world is far from ideal and the playing field on which banks compete is far from level. Com-

(Continued on page 42)

The New Kids On The Street Aren't Kids



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Asset Securitization

Everybody Wins

A great new A/L management technique. A partial cure for troubled ag banks. An economic stimulant. A new source of bank liquidity. Can securitizing bank assets really be all of that, and more?

By John L. Cleveland
Editor/Associate Publisher

IN THEORY, almost any set of cash flows with similar characteristics can serve as the raw material from which a saleable security can be forged. Banks sit atop huge mounds of such raw materials, and increasingly are learning to package these assets in ways the investment community finds attractive. In addition to their role as issuers of new types of asset-backed securities, banks are becoming more adept at utilizing such securities to restructure their balance sheets and diversify their loan portfolios.

The recent development of securities backed by consumer receivables and computer leases is the short-term counterpart of the well-established mortage-securities market, but the possibilities for pooling bank assets and converting them into marketable securities are only beginning to be explored. This trend is helping to make financial markets more efficient in transferring liquidity to segments of the economy where it's needed, say advocates, and providing investors with an ever-richer spectrum of alternatives.

In fact, the "everybody-wins" aura surrounding securitization of bank assets is perhaps the only disturbing aspect of this growing phenomena. Securitization almost seems too good to be true, but in the asset-to-security conversions that have occurred thus far, benefits indeed have flowed to all concerned parties. Financing flows to the consumer to purchase more goods and services. The financial institution gets a new source of liquidity and the investment community a new investment vehicle.

Short-Term Asset-Backed Securities

The $50-million private placement for Bank One, Columbus, on March 31, was the first — and so far only — use of revolving lines of credit to back a security. Bank One's CARDS (Certificates for Amortizing Revolving Debts[SM]) also are unique in their provision for a specified period in which they pay only interest.

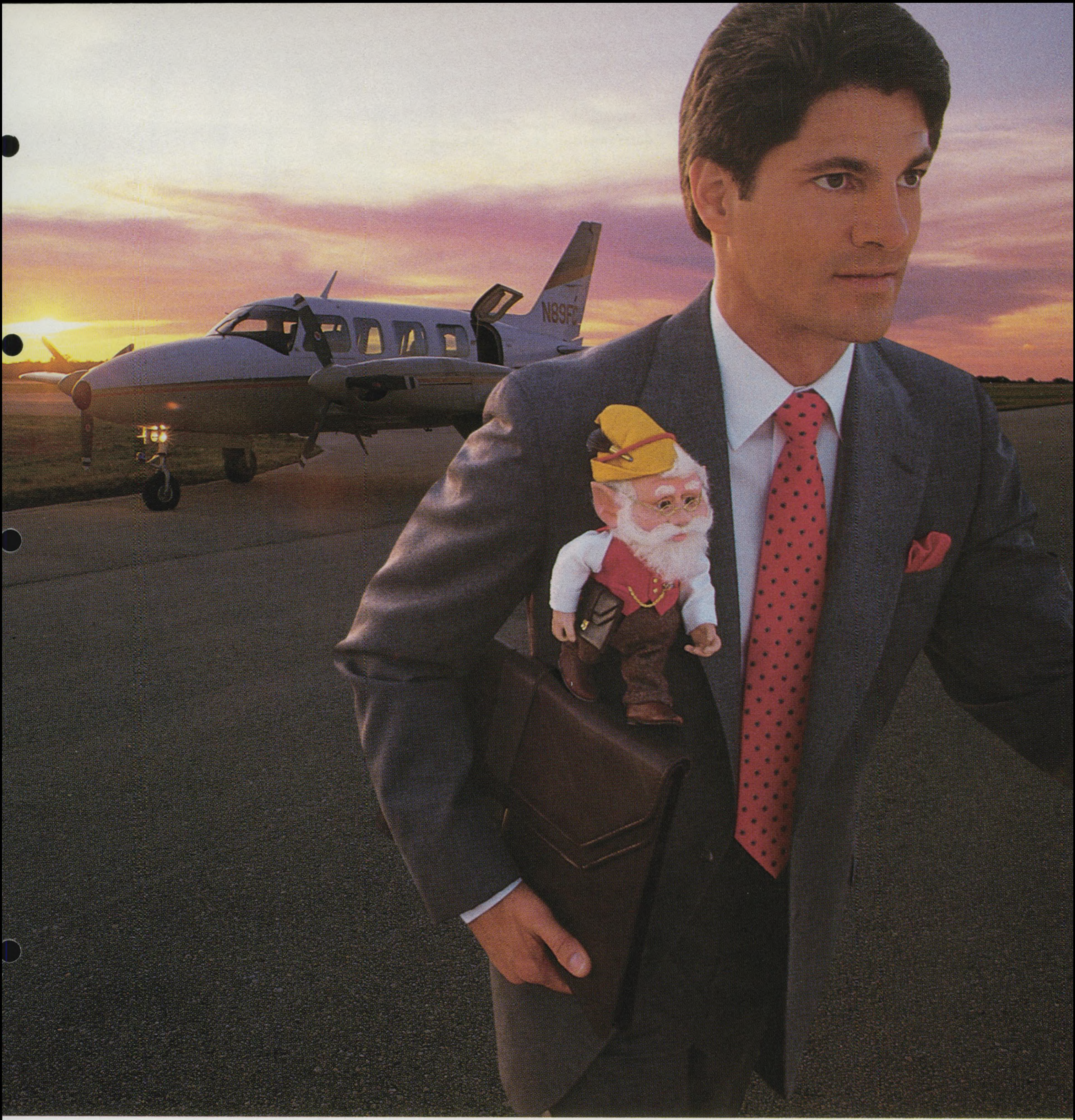
As of July 25, 12 public issues totaling $3.9 billion and several private placements of securities backed by automobile loans and computer leases had been sold, according to a booklet titled, *Introduction to Credit-Card Backed Securities*, published by Salomon Brothers, Inc., New York, underwriter for the Bank One offering.

"Total single-family mortgage debt — at an estimated $1.6 trillion (with $440 billion, or 28%, securitized) dwarfs the amount of consumer installment debt outstanding (which includes auto loans)," the booklet says. "The amount outstanding does not fully convey the size of the large market because the loans are repaid quickly. Total extensions of consumer installment debt in 1985 are estimated at an enormous $550 billion. The credit-card category had the highest volume at $250 billion, about equal to the originations of single family mortgages.

Commercial banks, followed by retailers and thrifts, are the largest potential issuers of credit-card-backed securities, according to Thomas Delehanty of Salomon Brother's Mortgage Research Department and with Michael Waldman, also of Salomon Brothers, co-authors of the booklet on CARDS. The principal motivation for institutions in issuing credit-card-backed securities is to free up regulatory capital to expand business and to diversify funding resources, he says.

Community Bank Involvement

Community banks are not likely to become primary issuers or purchasers of CARDS-type securities, Mr. Delehanty says. Smaller banks don't have the credit-card base nor the resources to go through the complicated and time consuming process of getting regulatory approval for securities backed by



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credit cards and the $5-million minimum buy-in for CARDS securities is attractive only to the largest of investors.

Yet Mr. Delehanty says that smaller institutions increasingly will pool different types of assets and convert them into securities just as they have in the mortgage market.

The first CMOs (Collateralized Mortgage Obligations) were done by the large homebuilders; then the thrifts started to get into the act," Mr. Delehanty notes.

Securitizing Ag Loans

Development of securities backed by agricultural loans is crucial to assisting ag banks diversify their loan portfolios so they are less dependent on one segment of the economy for growth, according to *Transitions in Agriculture*, a new report on the changing nature of U.S. agriculture issued last month by the ABA. In general, smaller banks and banks with more than 40% of their assets in farm loans have had the most difficulty in the current period of agricultural transition.

"Their problems do not stem directly from their size but from their high proportion of ag loans and from high-cost sources of loanable funds," the report says. "These smaller banks face challenges in remaining viable and competitive as their markets become more complex.

"Agricultural loans need to be securitized, much as home mortgages are, in order to insure a steady and adequate flow of capital to the agricultural sector," the report concludes. Michael E. Fitch, vice president, Wells Fargo, San Francisco, and outgoing chairman of the ABA's Agricultural Bankers Division, made a similar statement in a report to Congress last month.

The ABA has proposed that the federal government get involved in developing these pools and providing guarantees. But not everyone believes federal assistance is necessary before a market in securities backed by ag loans or other types of bank assets can become viable.

"For example, we think we could put together an excellent pool of agricultural loans," says Nate Collins,

Why A Secondary Market In Ag Loans Is Needed

On September 25, Michael Fitch, chairman of the ABA's agricultural bankers division and a vice president at Wells Fargo, San Francisco, presented testimony to the House Banking Subcommittee on General Oversight and Investigations in which he presented a case for establishing a secondary market in ag loans. Mr. Fitch's testimony is expected to prepare the way for action next year. An edited transcript of his remarks follows.

AS the financial-services industry developed in the 1960s, 1970s and 1980s, new mechanisms to permit more efficient and cost-effective allocation of capital were developed.

Secondary markets for loans to various sectors of the economy have been part of this development. Two good examples are the development of secondary markets for loans to students and to home buyers seeking mortgages.

These secondary markets for student loans and home mortgages provide access to capital which would otherwise not be directed to these purposes by turning the student and mortgage loans into securities. Originators of these loans sell them to entities such as the Student Loan Marketing Association (SALLIE MAE) or the Federal National Mortgage Association (FANNIE MAE). These entities assemble the loans into pools and sell securities backed by these pools.

Secondary markets, through the creation of these pools of mortgages which back securities sold to investors, match two economic interests: the investors who seek guaranteed income from the collection of principal and interest payments on the pooled loans, and the loan originators who must trade long term periodic payments for a lump sum payment in order to both match long-term lending with a reliable long-term source of funds and to retain liquidity.

The American Bankers Association supports the development of a secondary market for agricultural real estate for a number of reasons. However, one major reason is to ensure that the commercial banks of this country can remain competitive in agricultural lending. We feel it is important that commercial banks continue to be a major component of agricultural finance. The development of a secondary market for farm real estate will help to guarantee that continued involvement.

I served on a Joint Task Force of the American Bankers Association and the Independent Bankers Association of America that concluded a white paper on agricultural credit problems with the recommendation of the development of a secondary market. Our task force did so because it is one mechanism that will contribute to the continued involvement of commercial banks in farm lending.

Such a secondary market would enable banks to respond to a changing mix of demand and time deposits. Without a long-term source of funds that can protect a bank against a sudden shift in its deposit base, banks cannot become deeply involved in mortgage lending. But by increasing the liquidity of mortgages, a secondary market increases their investment quality. It would permit banks that are not traditional mortgage lenders in farm real estate to participate in this mortgage market.

In addition, a secondary market for farm real estate would facilitate the geographic transfer of funds from low to high loan-demand areas in the farm sector in the same way that it is now facilitating that transfer of funds in the home-mortgage sector.

The ABA firmly believes that opening these opportunities for commercial banks will result in the same advantages to farm borrowers that are now being experienced by home-mortgage borrowers and student-loan borrowers as a result of the development of secondary markets in those economic sectors. Mortgage rates have been driven down since secondary-market institutions have been able to tap sources of funds not traditionally available to the mortgage market directly. The same should be true of the agricultural real-estate market. The new sources of capital will be combined with advances in technology and telecommunications that are continuing to improve all phases of lending and securitization, thus increasing efficiency and decreasing costs to borrowers.

Today the Federal Land Bank component of the Farm Credit System already serves as a secondary market for that government-sponsored cooperative financial-services institution. Commercial banks are asking for the same type of access to capital for agricultural real estate that the Federal Land Bank now accesses by selling bonds to raise funds for real-estate loans. The Federal Land Bank already taps the long-term sources of capital that would be avail-

(Continued on next page)

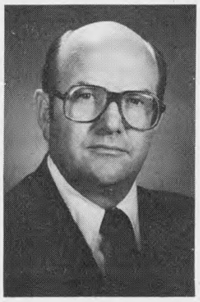
executive vice president/asset management, Valley National, Phoenix, which was among the first issuers of securities backed by auto and small-truck loans. "That's not to say we plan to do that, but we've considered it."

Mr. Collins, a member of a new ABA-Robert Morris Associates (RMA) cooperative task force on securitization, says he is concerned about the credit and documentation standards of the packages of huge commercial loans put together for resale by money-center banks to smaller institutions. He says he believes the ABA-RMA committee will have developed voluntary guidelines bankers can use in putting together such packages and in evaluating them from an investment perspective before the end of the year or by early 1987.

SBA Loan Pools

Driven by the pressure to improve capital adequacy and seek out new sources of liquidity, larger banks can be expected to continue to experiment with aggregating loans with similar characteristics and selling them to investors. Issues of new CARDS-type securities probably will continue to be private placements until third-party credit enhancements become available, according to the Salomon Brothers booklet. However, when third-party credit enhancements become available and rating agencies become more familiar with credit-card assets and deal structures, public offerings will follow.

Earlier this year, First Wisconsin National, Milwaukee, became the first bank in the country to participate in a new Small Business Administration (SBA) loan-pooling program. For several years, individual SBA-guaranteed business loans have been available through a secondary market under which a private lender sold the guaranteed portion of the loan via a broker/dealer to an investor.



Nathan Collins, e.v.p./asset management, Valley Nat'l, Phoenix, is a member of the ABA-RMA cooperative task force on securitization.

The new pooling program allows investors to buy shares in a pool of at least four SBA loans (none of which can account for more than 25% of the overall pool) with a minimum total value of $1 million. First Wisconsin has had two such offerings this year, both in the $1-million to $1.5-million range. Frank Pipp, assistant vice president, says that First Wisconsin sees SBA loan-pooling participation as an opportunity to learn about securitization of assets for a future in which such skills probably will be necessary for banks above a certain level of assets.

A desire to get the maximum educational benefits from the experience was partially responsible for First Wisconsin's decision to bypass the normal broker/dealer network with its SBA loan offerings. Mr. Pipp emphasizes that First Wisconsin continues to maintain excellent relations with broker/dealers around the nation, but that the bank's long experience in SBA lending and the apparent strong demand for such securities convinced management to sell the SBA "certificates of participation" directly.

Since the bank could not legally assume ownership of securities backed by its own loans, the certificates had to be presold before they were created. First Wisconsin sold the certificates primarily to well-known institutions located in its own market area, according to Mr. Pipp.

First Wisconsin's SBA loan pools are among 22 such pools nationally, only

(Continued on page 42)

Secondary Market *(Continued)*

able also to commercial banks through the development of a secondary market.

An ABA-commissioned research study, recently completed, suggests the following advantages of a secondary market for agricultural real estate loans:

1) Access to more capital, which would enable banks to continue making loans to farmers.

2) Reducing the credit risk of local, single-industry lending (lending to agriculture in small towns in the Midwest, for example) by selling loans into a secondary market to spread the risk.

3) Offering banks an opportunity to specialize. A bank could perform a single function, such as servicing loans, which would increase efficiency and decrease costs. (The ABA expects that many smaller agricultural banks would function primarily as retail outlets and servicing operations for real-estate loans which could be pooled and sold by large, money-center banks).

4) The addition of real-estate mortgages as a product that a bank could sell will enable agricultural banks to remain competitive and remain involved in financing agriculture. Without this development, such continued involvement will be made more difficult as other financial-services institutions encroach on the traditional lines of business followed by commercial banks in the farm sector.

Farmers would benefit from an agricultural secondary market in much the same way that homeowners have benefited: more competitive credit would be available and, therefore, interest rates would be lower and servicing should be improved.

H.R. 5132 utilizes the framework of the existing secondary markets in student loans and home mortgages as the basis on which to develop a secondary market for agricultural real estate. As such, it has the great advantage of being based on institutions that now are working well for commercial banks. However, the financial-services industry is developing and there are new concepts which are being utilized today that were not even considered when these first secondary markets were developed by the federal government. Some of these concepts may be usefully incorporated into a federally sponsored secondary market for agricultural real estate. For example, while it is clear that the underwriting standards for such a secondary market are absolutely crucial to its long-term success, it is not clear that the development of a large federal agency is necessary to develop and enforce these standards.

Recognizing the budget constraints now facing the Congress and the federal government, ways should be explored that would reduce and eventually eliminate actual cash outlays to the federal government of a secondary market. The figure of $200 million proposed in H.R. 5132 may be able to be raised in some other fashion or reduced considerably by greater involvement by the private sector in the development of a secondary market.

The ABA believes that it is absolutely essential that commercial banks have the power to underwrite and deal in these securities, as they do in the securities of other secondary markets created by the federal government. This power must be clearly delineated in federal legislation. ● ●

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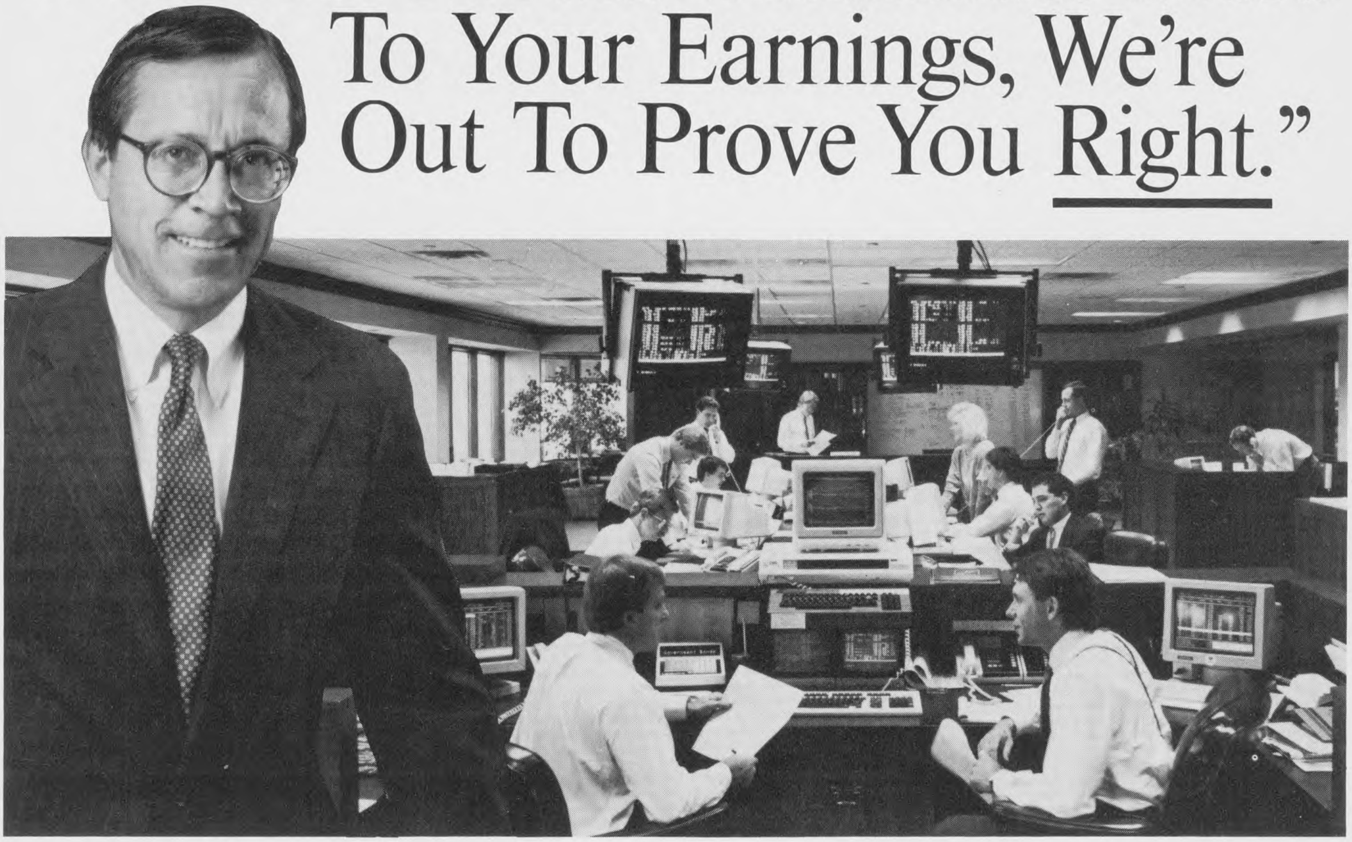

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Site Contamination: Major Risk for Lenders

Banks face costly dilemma when foreclosing a borrower's site that is contaminated

By Jim Fabian
Senior Editor

A BANK is faced with a foreclosure action on a loan that would result in the bank's ownership of land that has been nominated for Superfund clean-up status. If the bank forecloses it assumes liability for the clean-up, which may cost millions of dollars.

What's the bank to do?

"It's usually too late for it to do anything but walk away from the situation," advises Bob Zoch, president, Resource Engineering, Inc., (REI) an environment-management firm headquartered in Houston.

Hazardous-waste issues are adding another layer of potential risk to banks making commercial loans, Mr. Zoch says. And not many bankers are fully aware of the consequences.

In the instance cited above, the bank bore no responsibility for the condition of the site, yet, if it took control through foreclosure, it would have to assume that responsibility from the polluting firm, Mr. Zoch says.

"The liability is joint and several," he adds. "Any responsible parties could bear the cost of cleanup." In this case, "responsible" doesn't necessarily mean the polluter but the party that takes title to the site.

"Banks are scrambling to protect themselves," Mr. Zoch says. "When they consider the options, they realize they can't foreclose without placing the bank in jeopardy. The collateral often is useless if it's contaminated. So they have little choice but to walk away from it."

Even if a site doesn't qualify for Superfund status, he says, a bankruptcy court can require the trustee to satisfy any environmental issue before claims are permitted to be paid. Thus it could take years for the bank to be paid and the cost of cleaning up the site could exceed the value of the estate.

These situations should signal to commercial lenders the importance of making sure a borrower's site is contamination free at the time a loan is made, consultants say. Lenders also should make every effort to monitor a site during the loan term to make sure contamination is not taking place.

REI assists banks in assuring that sites are contamination free. It does this by conducting "fatal-flaw" analyses at the time a property changes hands or if the lender suspects contamination is taking place.

Commercial bankers can obtain assistance in assessing potential hazards of a borrower's site from firms that conduct on-site investigations.

REI personnel study past operating practices at the site in question. The firm's staff of chemical engineers conducts a "desk-top" evaluation that includes a review of past regulatory history of the site. Personnel examine state enforcement files that contain inspection reports made by officials who supervise firms engaged in operations that could result in environmental contamination.

If extended studies are called for, REI people conduct on-site inspections, looking for evidence of spills. They also interview plant personnel to learn how waste has been handled over the years. They ask if the firm has buried any containers "on the back 40" at any time. If it has, a determination is made as to the effect of such disposal.

The next phase is to test to determine if a spilll has occurred on the property, Mr. Zoch says. Groundwater contamination is the most common result of a spill. If evidence of contamination is found and the property is about to be sold, the seller must set up a fund to pay for correction of the situation before the sale can be consummated.

In the past, bankers were advised to be leery of lending to firms in the refining and petrochemicals businesses, Mr. Zoch says, but he recommends that the electronics industry be added to the "watch" list. Bankers should insist that there be proof that no contamination of sites involved has occurred before they lend to such firms.

Mr. Zoch is familiar with a situation in which a transformer blew up at an electronics firm. The explosion spread PCBs around the building, but his firm's audit of the area made note of the situation and advised both the firm interested in buying the property and the bank that was expected to handle the financing.

Most regional and money-center banks are aware of the dangers of environmental contamination, Mr. Zoch says. Some have joined a group known as the Society for Risk Assessment. This group puts on seminars that instruct attorneys, lenders and others concerned about environmental contamination how to avoid the dangers of such situations.

The situation can only become worse for commercial lenders, Mr. Zoch says, because Superfund legislation has passed in Congress. That means 500 new contaminated sites will be added to the Superfund list each year. These won't be only abandoned sites, he adds, since most contaminated abandoned sites already are on the list.

And banks aren't expected to fare any better in bankruptcy courts, since judges and juries are siding with en-

forcement agencies that are calling for cleanups of contaminated properties involved in estates prior to distribution of assets.

The site-contamination situation is prompting Robert Morris Associates (RMA) to take action to assist its members, says Dennis Edwards, chairman of the RMA's regulatory/legislative committee.

"The RMA soon will publish a white paper on this topic for its members," he says. "The project has high priority." Mr. Edwards is senior vice president, Chase Bank of Arizona, Scottsdale.

He terms site contamination a major problem in certain areas of the U. S. Problems aren't limited to major industries, he adds, citing instances of gas stations with leaking storage tanks that are polluting city water systems.

Mr. Edwards says it's difficult for a bank to monitor pollution once a loan has been made, but every effort should be made to make sure the borrower is conforming to pollution standards established by whatever government entity is involved.

He thinks commercial lenders are becoming more aware of the dangers site contamination poses for banks. Smaller banks with little expertise on the topic probably would refuse to take on a customer if there was danger of contamination. Larger banks typically call in outside assistance to determine if a site is contaminated.

Law firms are conducting seminars on site contamination that provide valuable information to lenders and other interested parties.

One such firm is Gage & Tucker, Kansas City. It publishes a legal newsletter called "The Advisory." A recent special issue reported on the increasing liability facing parties involved in contaminated properties. The information is directed at buyers and sellers, and it can be passed on to borrowers by lenders.

Attorney Don F. Dagenais advises in the special issue that buyers and sellers of property take steps to ensure that their interests are protected from environmental liability to the extent possible. Among steps they can take are the following:

- Identify and assess potential liabilities by getting the facts on both the environmental condition of the property and the environmental record of the seller.
- At closing, establish the environmental condition of the property as of the date of transfer, perhaps including a sampling and assessing program.
- Whenever possible, secure adequate disclosures, representations, warranties and releases.
- Be certain that documents relating to the environmental condition of the property are reviewed by counsel familiar with changes in the law.

Borrowers taking these steps place themselves in a more advantageous position to obtain financing.

Gage & Tucker states that increases in funding for Superfund and state hazardous-waste programs will result in increasingly vigorous investigation and broadening liability for clean-up costs. ● ●

ERT, Inc., a resource-engineering firm, will sponsor three seminars next month. "RCRA and Property Transfer" and "Plant and Facility Decommissioning" will be held in Washington, D. C., on December 11; "Property Transfers" will be held in Pittsburgh on December 16. For information, call 713/529-9900.

Major Benefit Seen in Tax Bill

By James E. Hamman
CEO, Capital City Bank, Topeka

THE TAX bill mandates that corporate rates be reduced for the top rate structure from 46% to 34%. This 12% reduction is equivalent to $22,000 of additional before-tax income for each $100,000. This is a major benefit for any bank with a respectable ROA.

A new alternative minimum tax has been designed to prevent profitable corporations from avoiding any tax liability.

ACRS will be retained with minor adjustments to personal property. Major changes will impact depreciable real property by requiring longer lives and restricting computations to straight-line method.

An alternative $10,000 annual expense election could be provided for personal property. Investment credit will be repealed effective January 1, 1986. Past repeals have only resulted in temporary moratoriums followed by reinstatement.

Capital gains will be taxed as ordinary income and individuals may consider CDs a better investment. CD interest rates are paying a real rate of return and with the new tax bill the "return of my money will be just as important as the return on my money." Banks can market the economic advantages of CDs and not have to overcome current tax-law benefits of securities and tax shelters.

Consumer lending has been a valued source of revenue for banks. Will repeal of this interest deduction change the borrowing habits of consumers? Such habits generally do not consider after-tax impact. We probably will have no change in the standard questions:

- What is the interest rate?
- What is the monthly payment?

To partially offset the loss of an interest deduction, individual tax rates will be reduced, personal exemptions and standard deductions will be increased.

Healthy Economic Growth Seen by Wis. Economist

Real economic growth should increase to a healthy 4%-5% annual rate between now and the end of 1987, according to the chief economist at First Wisconsin Corp.

That growth will be accompanied by a sharp rise in inflation and a monetary policy that continues to be stimulative, said Clare Zempel at a First Wisconsin outlook seminar last month.

The economist also predicted a jump in real exports and a shrinking trade deficit; a 20% increase in interest rates and buoying stock prices. The stronger economy also could lead to an effort to reduce the federal deficit.

Risk of recession is "negligible" until late 1988, he added, at which point "the Fed will get around to dealing with accelerating inflation."

Inflation is likely to almost double from its current level of less than 3% over the next five quarters, Mr. Zempel said, due primarily to stabilizing oil prices. Monetary policy will remain stimulative with the Fed permitting at least a 9% rise in "M1" over the next five quarters.

Mr. Zempel said the federal trade deficit is ready to come down, reflecting the effect of a decline in the value of the dollar. He sees an 11%-12% increase in real exports between now and the end of 1987, which should provide a major boost to GNP growth.

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The D&O Situation: Will it Ever Return to Normal?

What will it be: expensive under-coverage or no coverage? Captive firms: are they offering too little, too late?

By Jim Fabian
Senior Editor

PREDICTIONS VARY concerning the return to so-called "normal" of the liability-insurance situation. But few, if any, expect a change for the better in the short term.

"The D&O underwriter is caught in the middle," says Roy L. Phillips of Muskie-Phillips Insurance Agency, Houston.

He has an extremely limited number of companies from which to select and he faces the fury of the banker when it comes to affordability of the product, Mr. Phillips says.

"A recent quote on a new bank was $38,600 for $1 million in coverage," he says. "Can you imagine the shock such a quote would give to a banker — not to mention his response to the underwriter?"

Mr. Phillips has been in the insurance field for 25 years, but says he has not yet been able to adjust to the broad swings of underwriting moods taking place.

The D&O situation, he says, has resulted in a condition of absolute fear on the part of underwriters. He's been watching the small number of D&O players come in and out of the market.

But Mr. Phillips sees a direction to which the current situation is pointing, and it's "back to the basics"; back to hard underwriting practices and thorough investigative practices to assure the status of each bank client.

The first echelon of defense for individual banks, he says, is selection of quality directors and employment of professional bankers.

"The day of directorships on any board for ego purposes is gone," he says, "because it can cause the gravest of consequences."

Board participation, even as the devil's advocate, will be the trademark of survivors, Mr. Phillips says. "Progress and creativity in any industry always has been sired by the bold stance of individuals who are not afraid to ask 'why' at board meetings." Recent events have brought home the realization to directors that their personal well being depends on their bank being well managed.

More well-managed banks will result from the liability crisis, Mr. Phillips says. Bank managements can't depend on examinations being conducted on a regular basis because regulators are stretched too thin to maintain normal examination schedules. Therefore, managements are forced to pay closer attention to how their people are running their institutions.

Mr. Phillips predicts it will be 1988 before D&O becomes more readily available. But, even then, coverage will be next to impossible to obtain for new banks and banks under $100 million in assets.

"The market will remain tough because the players want to give their capacity only to lily-white large banks," he says. Policies will be short-term and will not cover problems that surface after a given period of time, such as one year. Underwriters live in fear they will be called on to cover a situation that comes to light in the next century and they're making sure they will not perpetuate such a possibility in new policies.

The D&O crisis will be over for banks in about two years, says William H. T. Bush, bank consultant in St. Louis.

Banks will be more fortunate in this area than universities and hospitals, he states, because underwriters see banks as less risk prone than some other types of operations.

Easing of the crisis will come gradually, he adds, and signs of this easing already are appearing as underwriters begin to resume marketing efforts. Once these efforts begin, Mr. Bush says, price cutting follows.

In the meantime, however, he says a 200% increase in price, combined with a 50% decrease in coverage for D&O is considered to be a good deal for banks.

Captive Providing Coverages

It will be 1990 before the liability-insurance situation returns to anything approaching "normal," predicts Bill McWilliams at BancInsure, headquartered in Oklahoma City.

"The situation is going to get worse," he says, "because more markets are withdrawing coverage and putting up obstacles to obtaining coverage."

BancInsure is supplying D&O coverage to banks with up to $50 million

(Continued on page 26)

Delaware Eases Director Liability

Delaware has passed legislation that limits or exempts directors from liability under certain circumstances. The legislation is designed to enable firms such as banks to retain outside directors who otherwise would consider resigning because of the liability crisis.

The law takes the middle ground between protecting directors and shareholders, according to its author. It applies only to directors and not to officers and doesn't apply to breaches of so-called duty-of-loyalty situations, such as conflict of interest, or to intentional misconduct or illegal activity. Shareholders retain the right to claim director negligence in suits seeking to prevent mergers or other transactions, but only prior to their consummation.

The law requires approval from a majority of shareholders to effect any liability exemption.

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in assets that are members of state bankers associations sponsoring the captive firm. Six state associations currently are working with BancInsure, with 10 more in the negotiation stage, Mr. McWilliams says.

He expects more state associations to make inquiries about BancInsure because the ABA's attempt to create a captive-insurance firm appears to be faltering.

Maximum coverage available from BancInsure is $400,000, but many banks want $1 million, he says.

BancInsure isn't the be all to end all, he adds, because it can't accept banks that are experiencing problems. About 50% of applicants are turned down. However, there is an appeals process through the applicant's state association that can result in BancInsure taking a second look at an application.

"We have the broadest known application form in the industry," Mr. McWilliams says, but coverage has restrictions, such as exclusion from regulatory suits and "insured vs. insured" suits.

Many banks are looking at D&O premiums and deciding to self-insure, Mr. McWilliams says. They have no other choice.

ABA Committed to Captive

Although BancInsure is the first captive underwriter for banks, it isn't expected to remain the only one. The ABA has been working on a captive for its members for about a year, and some state bankers associations are creating captive firms to serve their members.

The quest for a captive firm that will be able to meet the needs of ABA-member banks for D&O and other insurance coverage has been somewhat illusive. The primary stumbling block is the fact that reinsurance has not been obtained, says Sheldon Golub of the ABA's press-relations staff.

But the ABA remains fully committed to meeting the needs of its members who want coverage, Mr. Golub says.

He reports that a firm has offered to provide up to $2 million in D&O coverage and up to $3 million in bond coverage through a plan that will not require reinsurance from a third party. However, the ABA would have to put some of its reserved funds into an escrow account to get the program off the ground.

The ABA's funds would be tied up only until capital of the captive reached a predetermined level, Mr. Golub says.

The association plans to survey its members to determine their interest in the coverages. An earlier survey asking members if they favored a captive firm resulted in more than 3,000 responses in the affirmative, he says.

It's too early to tell just what restrictions D&O from the ABA's captive firm would carry, Mr. Golub adds.

Difficulties Explained

One reason banks are experiencing difficulties obtaining D&O coverage they can live with is the fact that management waits too long before gearing up for renewal of coverage, says Douglas Austin, bank consultant.

"It's important not to wait until the last minute to gear up for renewal," Dr. Austin says. "At least six months should be allotted to the renewal effort."

It's important for a bank to be in the best possible condition at D&O renewal time, he adds. It should obtain applications from as many carriers as possible and they must be filled out truthfully and completely. A fraudulent application could result in denial or cancellation of coverage.

Consultants generally agree that banks should consider the maximum

(Continued on page 47)

Illinois Captive Gets Go-Ahead

MORE THAN 300 members of the Illinois Bankers Association have responded positively to a survey by the association that sought to enlist support for establishing a captive insurance firm.

Although 400 banks was the IBA's goal, its board has decided that sufficient interest has been expressed to warrant going ahead with establishment of the firm.

The association's counsel is working on an offering circular and solicitations are expected to be in the mail by December 1.

The IBA believes the project represents a unique opportunity for Illinois bankers to work together to solve their D&O problems without being dependent on the vagaries of the commercial-insurance marketplace, an IBA spokesperson said.

Commissioner Says Wisconsin Banks Are Tightening Their Managements

THE BEST way to avoid violations from the state banking commissioner's office is to tighten bank management.

This is what Wisconsin's banking commissioner has been telling bankers as he tours the dairy state.

Commissioner Richard E. Galecki saw the need for tighter management when he became commissioner less than two years ago. At that time he was surprised at the number of violations coming through his office. Among them were preferential-lending rates for directors and officers and excessive overlines.

He feels there has been a reduction in violations since he took office.

Another thing that has been surprising to Commissioner Galecki is the lack of acquisition announcements from banks intending to enter Wisconsin now that state-line crossovers are legal. At the time he spoke to the issue, no bank had moved into Wisconsin and only three Wisconsin banks had announced intentions to move into other states.

He expressed the belief that Wisconsin would not lose many banks. "We'll be buyers," he insists.

His office expects to be receiving requests for expanded powers provided by the state's interstate-banking law, although no rush has yet been apparent.

The law permits banks to offer any activity, product or service deemed financially related by the commissioner, such as travel agencies, insurance or real estate.

The legislation also expands banks' ability to make loans and investments of certain types and permits them to invest directly in business firms. That means a bank may make equity loans through the bank or a subsidiary, subject to approval by the bank's board, provided the amount loaned doesn't exceed 20% of capital and surplus or a lower percentage set by the commissioner.

Mr. Galecki was a banker for 25 years before being appointed commissioner.

Shop for Coverages: Lesson of Ins. Crisis, Says Bank Consultant

By Jim Fabian
Senior Editor

THE INSURANCE crisis has served to awaken many bankers to the fact that they must shop carefully for coverage, says a St. Louis consultant.

Gone are the days when a bank CEO merely let the insurance broker who sat on his bank's board take care of the institution's insurance needs in a routine manner, says William H. T. Bush, chairman, Bush & Kobusch Management Consultants, Inc.

It's often necessary for the bank to seek out a broker with the clout needed to secure the best deal for the bank, according to Mr. Bush, who sits on the board of Covenant Group, Hartford, Conn., insurance firm.

A savvy broker can keep the CEO abreast of the changes constantly taking place in the insurance industry, Mr. Bush says. Lately, it's been difficult to keep track of which firm is offering which coverages.

Not just any insurance broker should do, he adds, since the clout brokers have with underwriters varies, often based on the amount of business they send to underwriters they represent.

Mr. Bush suggests that CEOs (or chairmen of bank insurance committees) query prospective brokers as to their effectiveness in the everchanging insurance market.

"Ask the broker how much money he places through his major markets," he says. "If the amount is in the high-six figures, that broker is likely to have clout because he is entitled to lots of attention from the underwriter."

Ask the broker if he's a member of the producers' club of underwriters he represents, such as the Aetna Elite or the St. Paul Top Brass, Mr. Bush suggests. Club members are entitled to clout.

If the broker goes through Lloyd's of London, check out the stature of the broker with Lloyd's because stature determines the price of the products the broker offers the bank, Mr. Bush says.

Except for blanket bonds and directors and officers coverages, the insurance market for banks is pretty normal, Mr. Bush says. He adds that he feels bankers should be more concerned about the former type of coverage than the latter, for a surety bond is necessary for a bank to remain in business.

It's not surprising that carriers are more strict during a time such as this, he says. Most underwriters are being selective as to what they are insuring, not to mention who the broker is. Many carriers are putting the "80/20 rule" into full practice because they want to get the most for their efforts. When there is a shortage of product, the largest producers get first crack at what's available.

What's a bank to do to make it attractive to a carrier? Mr. Bush offers the following suggestions:

- Have an auditor who reports directly to the board, not the CEO. This is important for qualifying for surety-bond coverage.
- Conduct annual reviews of all risks in the bank's portfolio.
- Keep buildings and grounds in proper condition and maintain records of inspections and repairs.
- Fingerprint all people on the bank's staff.

A bank that has major loan problems faces a high litigation risk, Mr. Bush says. Actually, it's not the loan problems per se, but the litigation risk that results from the problems, that bedevil banks.

Mr. Bush is sympathetic to banking's plight. He realizes that external factors often are involved, and how is the banker to combat such factors? "It's easier to clean up the bank after a flood than it is to clean up a portfolio full of bad loans," he says.

Mr. Bush established his consulting firm recently after resigning as president, Boatmen's National, St. Louis. He was with the bank for eight years.

CBA Head Calls for Education IRAs

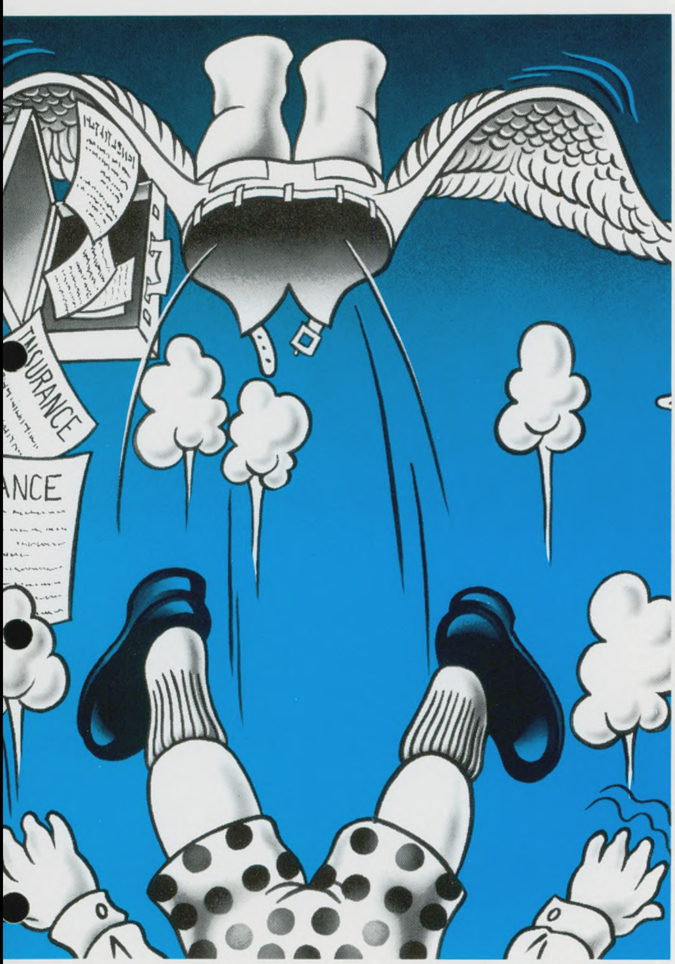
EDUCATION IRAs have been suggested as a means to narrow the growing gap between family incomes and the cost of higher education by Thomas E. Honey, president, Consumer Bankers Association.

"Parents and students need help with the orderly planning of college expenses," Mr. Honey said at the CBA's recent Second National Student Loan/Finance Conference. "They need products and services which will enable them to save, invest and earn for the ever-growing financial burden."

He called for IRAs for education savings, tax credits for principal/interest payments on loans for education, fair and equitable loans and grant/assistance programs as ways the federal government could extend "positive stimuli to encourage thrift and good planning" to parents and students.

Without such a comprehensive program, Mr. Honey said, "Our nation faces an evolutionary trend to a totalitarian society in which only a few who can afford it will receive the quality higher education essential to lead our government, manage our businesses and control our society."

He predicted that a four-year college education would cost about $100,000 by the turn of the century and added that the average student of today amasses an average debt of $12,000 during his/her college years.



Serious Problems for Banking Seen in Tax-Reform Legislation

By James Blackman
First Vice President
First Wisconsin Corp.
Milwaukee

BETWEEN an expanded definition of preference income and the adoption of an alternative minimum tax, the Tax Reform Bill poses some serious problems for the industry.

In addition, it could end up reducing marketability of the tax-exempt investment instruments favored by banks.

While the current corporate minimum tax is an add-on tax — an amount added to the regular tax liability — the minimum tax is an alternative minimum tax (AMT). Such a tax would require banks to compute their tax liability based on their regular taxable income and then compute the AMT based on preference income. If this exceeded the regular tax, the larger amount would be paid.

In addition, while the formula for calculating preference items remains similar to the one used for the current add-on minimum tax, the bill calls for a much wider definition of what constitute preference items. For instance, the bill would label as preference items:

- **Item 1.** Reserves for losses on bad debts in excess of actual experience.
- **Item 2.** The amount of accelerated depreciation in excess of depreciation calculated under an alternative straight-line method.
- **Item 3.** Half the difference between financial statement pre-tax income and taxable income.

These preference items, plus any others that might apply, would be added to regular taxable income. The sum of the preference items and regular taxable income constitutes the preference income, which is subject to a 20% AMT.

What would this mean for banks?

	Regular Tax	*A.M.T.*
Book income (pre-tax)	$1,000,000	$1,000,000
Tax-exempt income and other deductions	565,000	565,000
Regular taxable income	435,000	435,000
Half the difference between book and taxable income	NA	282,500
Amount subject to tax	435,000	717,500
	×33%	×20%
Tax due	$143,500	$143,500

Item 3 means that if the tax-exempt income and other timing deductions exceed 56.5% of pre-tax financial-statement income, the AMT applies. That percentage would be even lower if an institution had other preference items.

The chart shows how the tax due on ordinary income at the regular 33% rate is equal to what would be due under the proposed AMT system at 20%.

Judging from a review of the annual reports of a number of institutions, tax-exempt income for many is in excess of 56.5% of financial-statement pre-tax income. These institutions, before even considering other timing and preference items, would be subject to the AMT. In addition, any tax credits the institution would be entitled to may further reduce the level of tax-exempt income a bank could receive without being subject to the AMT.

Tax-exempt income for some banks comprises a material portion of pre-tax financial-statement income. In one case we studied, tax-exempt income actually exceeded pre-tax financial-statement income. In this instance, federal-tax expense for 1985 was negative. Under the proposed AMT, this institution would have incurred a federal tax bill equal to about 10% of its financial-statement pre-tax income.

A close reading of this bill leads to a conclusion that warrants attention from the industry: An alternative minimum tax plan similar to the one prescribed either will subject banks to greatly increased income-tax expense or force them to liquidate a significant portion of their tax-exempt portfolios.

NEWS BRIEFS

- **A. M. (Steve) Marzano** has been named vice president/sales, installation and service for Mosler, Inc. He succeeds Joe MacDonald, who plans to retire next April.
- **Henry C. Ruempler** has been named director of taxation for the ABA. He had been with Citibank's Washington office since 1983.
- **Nancy B. Wolcott,** vice president, Harris Trust, Chicago, has been named chairman of the securities-lending committee of Robert Morris Associates.
- **Friedrich M. (Fritz) Elmendorf** has joined the Consumer Bankers Association as director of public relations and communications. He previously was with the ABA's public relations department.

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Reducing Appraisal-Report Risk

The Sharp Decline in Appraisal-Report Quality in Recent Years — and Subsequent Losses to Banks — Demands Attention

Losses due to poor quality appraisal reports can be reduced significantly by raising the quality of appraisal reports submitted to financial institutions. This article tells how to do it

By Lori A. Laughlin

A GREAT DEAL of attention is given to quality control due to losses experienced by the financial industry. This attention has stimulated an interest in the subject of risk.

A major risk facing lending institutions — as well as the private mortgage-insurance industry and secondary market — is appraisal risk. Experience indicates there is a direct relationship between poor-quality loans and poor-quality appraisal reports.

An examination of loan packages in default at one large mortgage-banking firm revealed that 29 out of 30 properties were over-appraised. Many were substantially higher, some were appraised at two to three times their actual "fair-market" values. In addition, a large sampling of properties not in default revealed that 98% of the appraisers listed sales price as market value. If sales price is market value, we don't need appraisers! Financial-institution personnel already know the sales price.

Over the past 15 years, there has been a sharp decline in the quality of appraisal reports throughout the nation. Real property, for a variety of reasons, has been over-appraised, creating the possibility for substantial losses.

The "fudge factor" in appraising has increased dramatically over the years. For companies underwriting loans, this has meant that what should have been a small loss, if the appraisal report were accurate, became a very large one. Many properties in default would not have been underwritten had the underwriter been told the truth.

Thus, appraisers are in part responsible for much of the loss experienced by the financial community. However, the primary cause of losses lies within the financial institutions themselves. Market-share quest has caused many financial organizations to abandon past standards as well as traditional defense systems.

It's obvious that much of the loss that has occurred in the financial community could not have happened without collaboration between loan officers and appraisers. Thus, the relationship between poor-quality appraisals and poor-quality loans may not be one of correlation but causation.

If the lending community were serious about managing risk, it would break the connection between sales and appraising because they don't mix. Mixing has perverted the appraisal process. The appraiser's role is to offer an independent third-party value opinion. Thus, the appraiser's work should provide an important check within the lending system.

Unfortunately, many appraisers have lost their independence and have become part of the system. In real estate, almost everyone is an advocate. However, this is not the appraiser's proper role. Unfortunately, in many firms sales people select appraisers and order appraisal reports. This is inappropriate because appraisal reports are

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Ms. Laughlin is executive director, Professional Women's Appraisal Association, Scottsdale, Ariz.

Appraisers Called Threat to Banks

THE REAL-ESTATE-appraisal industry has been termed a shaky profession that threatens the safety and soundness of the nation's financial system by a congressional-committee study.

The study suggests extensive renovations to the industry that include self regulation and federal oversight.

The study says that "appraiser ineptitude, negligence and misconduct are widespread." It adds that these factors are in large part responsible for recent real-estate-related failures of financial institutions as well as for billions of dollars in losses at banks, thrifts, credit unions and mortgage-banking firms.

The report says Bank of America, Wells Fargo and Continental Illinois National banks had combined appraisal-related losses of more than $300 million in recent years. Blame is to be shared with banks and regulators, according to the study. "Many lending-institution executives, directors and loan officers are either essentially ignorant of or ill-informed about the proper role of real-estate appraisals in loan underwriting," the study states.

"Worse still, many such officials maintain that it is not difficult to find an accommodating appraiser who can be counted on to come up with whatever results are desired," the study states.

Congressman Doug Barnard Jr. (D., Ga.) plans to introduce legislation next year to deal with this situation. The legislation is expected to create a self-regulatory body for appraisers and give regulatory agencies authority to discipline offenders.

underwriting, not sales, tools.

Financial institutions can save millions by becoming concerned with the issue of appraisal quality control. The best way to manage risk and ensure profitability is to do a good job of underwriting. This involves ensuring the quality of documentation received by financial organizations. Sound underwriting means fewer problems to address in the future. In fact, a risk-management philosophy and sound underwriting, combined with well-conceived quality-control programs, are the keys to the survival and profitability of financial institutions.

Following are some tips on protecting banks from appraisal and other types of real-estate risk:

- Implement appraisal, project and loan quality-control programs. Ascertain reasons for company losses and design programs to address the problems.
- Maintain a market-analysis capability. Attention should be given to areas experiencing economic problems. Particular concern must be directed to over-built markets where investor speculation and creative financing schemes are apparent.
- Develop tracking and monitoring systems that will reveal areas that need to be addressed. Tracking and monitoring activities are part of a bank's defense system, used to protect and direct themselves.
- Train underwriters so they will be able to review appraisal reports intelligently. This task is part of the company's ongoing educational effort.
- Encourage the bank to relate appraisers to an underwriting, appraisal, or quality-control department. Sales people in financial institutions should not be allowed to select appraisers and order appraisal reports.
- Require narrative appraisals on custom homes and high-risk properties. FNMA/FHLMC forms are not adequate for such properties. On certain types of properties and loans, financial institutions need a more in-depth look at the real estate providing security for the loan as well as a more in-depth look at the surrounding market. Narrative appraisals cost more than form appraisals but, considering the chance of loss involved in high-risk and high-dollar properties, they are bargains.
- Don't give appraisers the sales price of a property being appraised unless the appraisal request is part of the company's spot-check program. Lending institutions should be encouraged not to divulge the sales price to the appraiser. If the appraiser learns the sales price, that price will be listed as the market price about 98% of the time.
- There should be a complete separation between sales and underwriting departments. Sales departments must not be allowed to control, direct, or pressure underwriting personnel. Underwriting should be allowed to fulfill its mission. At one company I worked for, sales determined underwriting policy and, in addition, sales managers reviewed underwriters for their annual salary increases. Obviously, the system was designed to overwrite rather than underwrite.
- In contacts with appraisers, let them know you want quality appraisal reports. Financial institutions will have to convince appraisers that they will be rewarded for doing good work. In recent years, the system has rewarded poor quality work and punished good quality work. If financial institutions were serious about managing risk, they would protect appraisers from being punished by loan officers.
- Counsel with appraisers who do questionable work and attempt to get them to improve the quality of their work. Counseling has a positive effect on the quality of submitted appraisal work and will resolve most problems.
- Monitor appraisal reports and eliminate appraisers who consistently do poor quality work. If an appraiser continues to submit poor quality work after counseling, use the services of another appraiser.
- If an appraiser is consistently doing poor quality and/or unethical work, submit the poor-quality reports to the ethics committee of the appraisal society of which the offender is a member.
- Quality control, appraisal and underwriting departments in financial institutions should relate directly to senior management. It is recommended that these departments be headed by individuals at the vice-president level.
- Review questionable appraisal reports before the loan is underwritten. Don't be afraid to get a second opinion. Engage in preventive medicine — it's preferable to post mortems!

A prudent bank will maintain sound underwriting practices and obtain appraisal reports that meet professional standards. This will enable the bank to arrive at judicious loan-underwriting decisions.

The purpose of any appraisal quality-control program is to ensure that the information received for loan underwriting or any other purpose is complete, consistent, reliable, accurate and free from fraud. In brief, submitted appraisal reports must be of acceptable quality. Quality information will allow the bank to make sound risk decisions. Judgments based on poor quality or faulty data will increase the bank's chance of loss. • •

BBB Now FIB; Note Changes!

IT MAY be taking considerable time for the new name for the bankers blanket bond to take hold, but bankers should be aware of the changes contained in its successor — the financial institution bond (FIB).

A brief summary of these changes was given to bankers attending a recent seminar hosted by the St. Louis office of Peat Marwick by Mark H. Cummings, senior manager.

The bond now is a definite-term contract. It's no longer open ended. This permits the underwriter to apply the aggregate liability limit for all losses discovered during the bond period on an annual basis instead of a continuous basis.

Loan losses caused by employee dishonesty are not covered unless the employee receives a financial benefit of at least $2,500 for himself/herself.

The insurer no longer is required to indemnify the bank for court costs and attorney's fees. If the insurer elects to defend legal proceedings in full or in part, only legal expenses incurred by the insurer are covered.

The application for FIB is made a part of the bond and misrepresentations or omissions are grounds to void the contract.

Mr. Cummings recommended that renewal applications be made three months in advance of bond termination. Ask for a 30-day turnaround to give the bank time to shop around if the new terms are not to management's liking, he advised.

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Tax-Reform

Are Banks Bearing Brunt of Burden?

By John O. Eichhorn and Daniel J. DeMoss

TAX REFORM has become law. After nearly two years of debate, the Joint Congressional Committee reached an agreement in August on an outline from which the new tax bill was drafted. The drafted bill moved swiftly through House and Senate debates and was overwhelmingly approved by both branches of Congress and received the president's signature on Oct. 22.

The 1986 Tax Reform Bill marks the most substantive reform of our tax laws since drafting of the 1954 Internal Revenue Code.

Due to the prevalent belief that corporations, particularly financial institutions, receive unjust preferential treatment under the current system, tax reform will eliminate these "inequities" in our tax system. The banking industry not only will be affected by the major overhaul of general corporate provisions but also by changes to the specific provisions relating to financial institutions.

This article will summarize the main provisions of the Tax Reform Act of 1986 affecting banks. We suggest you use this article only as a guide. You should consult your tax advisor to determine how the provisions may affect your institution.

Corporate Tax Rates

A principal objective of the bill is to reduce marginal tax rates on income taxes paid by individuals and corporations. The top marginal rate paid by corporations would be reduced from 46% to 34% for taxable years beginning after July 1, 1987.

Taxable Income	*Prior Law Rate*	*New Law Rate*
$ 0 - 25,000	15%	15%
25,000 - 50,000	18%	15%
50,000 - 75,000	30%	25%
75,000 - 100,000	40%	34%
Over $100,000	46%	34%

The conference agreement also imposes a 5% surtax on taxable income between $100,000 and $335,000, thus totally eliminating the benefits of lower tax rates when taxable income exceeds $335,000. Calendar-year taxpayers will have a blended rate with a top marginal rate of 40% for 1987 (excluding the 5% surtax).

Mr. Eichhorn is a liaison tax partner in the commercial-banking practice and Mr. DeMoss is a senior tax specialist. Both are in the St. Louis office of Peat, Marwick, Mitchell & Co.

Capital-Cost Recovery and Investment Credit

The committee wanted to retain the simplicity of the present law's accelerated cost-recovery system, which provides a small number of depreciation classes and relatively short recovery periods. Under the new law, the recovery period for automobiles and light trucks would be extended from three years to five years, while most furniture, fixtures and equipment would be extended from five years to seven years, applying the 200% declining-balance method.

The tax bill eliminates the so-called inequities favoring banks in the current tax system through a major overhaul of general corporate provisions and changes to specific provisions relating to banks.

Residential real property will be recovered on a straight-line basis over 27½ years, while non-residential real property will be recovered on a straight-line basis over 31½ years. The mid-year convention will apply to the five- and seven-year classes, and the mid-month convention will apply to the 27½- and 31½-year classes. The $5,000 annual first-year expensing limitation is raised to $10,000; however, it is available only to taxpayers with property of less than $210,000 placed in service during the taxable year. Where such aggregate cost exceeds $200,000, the limitation is reduced dollar-for-dollar. The effective date for depreciation changes generally will be December 31, 1986.

The conference agreement repeals the investment-tax credit effective for property placed in service after December 31, 1985. Investment-tax-credit carryovers will be reduced by 35%. The reduction in investment-tax-credit carryovers is phased in with the corporate-rate reduction. The 35% reduction is fully effective for taxable years beginning on or after July 1, 1987. Taxpayers having a taxable year that straddles July 1, 1987, will be subject to a partial reduction that reflects the reduction for the portion of their year after that date. For example, for a calendar year taxable year, the reduction for 1987 is 17.5%.

Corporate Alternative Minimum Tax

For taxable years beginning after December 31, 1986, the agreement repeals the present add-on minimum tax for corporations and replaces it with a new alternative minimum tax. The alternative minimum tax rate will be 20% of alternative minimum taxable income that exceeds $40,000. The $40,000 exemption will be reduced by 25% of the amount by which alternative minimum taxable income exceeds $150,000. Alternative minimum taxable income will be computed by adding certain tax-preference items for the year to regular taxable income. Preference items applicable to banks generally will be the same as those used in computing current add-on minimum tax, with the addition of the "business untaxed reported profits" preference item.

The business untaxed reported profits is equal to one-half of the excess of pre-tax book income of the bank over its alternative minimum taxable income before this preference is taken into account. For example, a bank with pretax book income of $1,000,000 consisting of $800,000 of municipal income and no other book/tax differences and preference items would have a regular tax liability of $61,250, but under the alternative minimum tax would have a total tax liability of $120,000, as follows:

Taxable income	$200,000
Tax preference items:	
Business untaxed reported profits	
½ (1,000,000-200,000)	400,000
Alternative Minimum Taxable Income	$600,000
Alternative Tax (at 20%)	$120,000

Limitation on the Use of Cash Basis of Accounting

The agreement would require all cash-basis corporations to switch to the accrual basis of accounting if, for all prior taxable years beginning after December 31, 1985, such corporation has average annual gross receipts for the three-taxable-year period ending with such prior taxable period greater than $5,000,000. The change will be required for tax years beginning after December 31, 1986. The amount of the adjustment would be spread over a period not to exceed four years.

Mergers and Acquisitions

The agreement repeals the General Utilities Doctrine, which generally allowed non-recognition of gain at the corporate level in liquidation. This doctrine also allowed corporate acquirors of stock to elect to treat the purchase of stock as a purchase of assets. In these situations, otherwise non-deductible premiums could be assigned to assets such as fixed assets, marketable securities, etc., that would produce a tax benefit. With the repeal of the General Utilities Doctrine, gain generally will be triggered on the step-up in basis of the assets. Therefore, except in unusual situations, the election to step-up basis in assets on a stock acquisition will not be favorable. Such a step-up would require the payment of tax on gain today for future tax deductions, the opposite of good tax planning. Certain exceptions for non-recognition are provided and transitional rules may apply to certain liquidations and stock acquisitions.

New Operating Loss Carrybacks and Carryforwards

Under current law, banks are permitted to carry losses back against taxable income from the prior 10 taxable years and over to the succeeding five taxable years. The agreement treats banks under the same operating loss provisions applicable to other corporations (i.e., carrybacks will be permitted to the prior three taxable years and carryovers to the succeeding 15 taxable years). These provisions will be effective for losses incurred in taxable years beginning after December 31, 1986. Commercial banks will be allowed a 10-year carryback for the portion of a net operating loss attributable to deductions for bad-debt losses incurred in tax years through 1993.

Loan-Loss Deductions/Recovery of Existing Reserve for Loan Losses

Under present law, banks are allowed a deduction to provide a reasonable addition to the reserve for losses computed under the experience method or the percentage-of-eligible-loans method. The committee believes that deductions under the reserve methods allow deductions for losses that may or may not occur. Therefore, the agreement provides that for large banks (average assets of bank or controlled group in excess of $500 million) the reserve method of accounting for bad debts generally should be repealed, allowing bad-debt losses to be deductible only as loans are charged-off. The agreement retains present law regarding the use of reserves in computing the deduction for losses on bad debts for small banks (average assets less than $500 million). The tax-reserve account would have to be recaptured as income over a four-year period for large banks. The recapture rules do not apply to smaller banks or to troubled banks (non-performing assets exceed 75% of capital).

Interest on Debt Used to Purchase or Carry Tax-Exempt Obligations

Under present law, interest expense on indebtedness incurred or continued to purchase or carry tax-exempt obligations purchased prior to January 1, 1983, is fully deductible, while 20% of such interest expense allocable to tax-exempt obligations purchased after December 31, 1982, is non-deductible. The conference agreement disallows 100% of the interest expense deemed allocable to tax-exempt obligations acquired after August 7, 1986, for taxable years ending after December 31, 1986. A special exception was provided for governments and their subordinated entities that issue less than $10 million in obligations in a year that allows these small-issuer obligations to remain under the old 20% interest-disallowance provisions.

Fundamental Tax Principles Still Apply

Assuming that a bank's 1986 marginal tax rate is 46% and a marginal tax rate of 40% (calendar-year banks) in 1987, deductions should be maximized in 1986 and income should be deferred into 1987. Cash-basis banks will have considerable flexibility of timing of income and expense.

Any contemplated fixed-asset additions should be purchased prior to year-end. Not only will the bank be entitled to depreciation in 1986, but a shorter recovery period will apply to pre-1987 additions. Should the bank be in an alternative-minimum-tax position in 1987, accelerated depreciation on personal property placed in service after 1986 will become a preference item in computing the new alternative minimum tax.

Any investment-credit or other business-credit carryovers should be utilized in 1986 if possible. Credit carryovers not utilized in 1986 will be reduced by 17½% to 35%.

Are Munis Still Alive?

Because of the 100% interest-expense disallowance, it generally becomes unattractive to buy or sell grandfathered securities (obligations originally purchased prior to August 7, 1986). Sellers of grandfathered tax-exempts generally will suffer an economic loss as the securities will yield less on an after-tax basis to the purchaser subject to the 100% disallowance than to the seller (and subsequently sell for less).

Purchases of new issues that qualify for the small-issuer exception will remain under the old 20% interest-expense disallowance. After-tax yields on these securities still may be beneficial.

A small benefit still may be derived on new tax-exempts. Should the yield on a tax-exempt security exceed the bank's cost of funds, the spread in rates will be non-taxable. It should be noted that when a bank's cost of funds exceeds the rate on a tax-exempt security, the income effectively will be taxed in excess of 100%.

Maximize Bad-Debt Deductions

For large banks (assets greater than $500 million), 1986 will be the last year for use of the reserve method. Assuming a 46% rate in 1986, all questionable loans should be charged-off (within capital-and-earnings constraints) in addition to maximizing the tax reserve for any bad-debt-deduction deferrals from prior years. The reserve then will be recaptured over four years at the lower marginal rates.

Banks with assets less than $500 million will be allowed an experience deduction with no recapture of their bad-debt reserve. However, the base year under the experience method will be 1987 for all banks, starting in 1988. In view of this change, the bad-debt reserve should be maximized at the end of 1987.

Generating Net Operating Losses

If a bank has built-in losses in its assets, consideration should be given to disposing of these assets and generating a net operating loss to recover taxes at 46% in the previous 10 years. After 1986, losses (except those relating to bad debts) will only be able to offset income in the previous three years. In addition, with the new law in effect, generating a net operating loss to recover taxes will be more difficult.

Alternative Minimum Tax

Consideration should be given to setting up and monitoring budgets and taxable-income projections in 1987 so as to avoid or at least minimize alternative minimum tax in light of the "business untaxed reported profits" preference item.

Under the new law, it will be necessary for banks to review their business plans to ensure that resources continue to be allocated productively and at acceptable level of risk. Asset-and-liability-management policies should be analyzed, as after-tax yields on investments will change. Year-end planning for 1986 and budgeting for future years should include consideration of tax reform, as the changes may dramatically alter cash flow and income projections.

Your tax advisor should be consulted to analyze the effects of tax reform of your institution. • •

Correction. The author's name appearing with the article "In Business For Business" on page 12 of the October issue was incorrect. It should have read "By Ira Nathanson, marketing director, Affiliated Banc Group, Chicago."

Banks Taking Bum Rap, Says a Feisty Senterfitt

ABA president's tough talk indicative of greater determination and unity on need for competitive equity

By John L. Cleveland
Editor/Associate Publisher

A FEISTY Donald Senterfitt, outgoing ABA president, took to the podium at last month's annual convention to lament the "bum rap" the banking industry has taken for recent problems and to pledge that the ABA will continue to work for competitive equity.

The determination Mr. Senterfitt displayed in his remarks at the start of the convention was picked up by other speakers as the convention continued.

"To the doomsayers of banking, I have a message and I want them to listen very carefully," Mr. Senterfitt, vice chairman, SunTrust Banks, Inc., Orlando, Fla., said in his final speech as ABA president. The banks of America are more than equal to the new challenges facing them and will "maintain — nay, increase — our preeminent position in the financial world."

The banking industry has been the target of criticism for the rash of bank failures, insensitivity to customers' needs, alleged selfishness in the pursuit of new products/services and self-serving legislation, Mr. Senterfitt said. "Votes against us in Congress and the silent votes against us in the (Reagan) administration show that the nation's banks are taking a beating for all the wrong reasons," he emphasized. "We've got to turn things around," he said, and then added a refrain that would be heard several times during his speech, "and we can."

ABA's solutions to the problems in the financial industry too often are viewed as anti-consumer, according to Mr. Senterfitt. "To make the ABA the most respected, most listened-to expert on financial-community deregulation, let's talk directly about what our proposals will bring to the consumer," he said.

Mr. Senterfitt pointed out that he has asked the Reagan administration to become more involved in the development of a new, forward-looking national policy on banking.

"Today, I repeat that call to the President and his administration," said Mr. Senterfitt. "I remind them that the last time banking policy was brought into alignment with national policy was 50 years ago. That policy is in tatters today — a haphazard patchwork of rules, loopholes and compromises prevents banks from fully serving the national and public interest."

In order for Congress and the Reagan administration to take the banking industry's policy proposals more seriously, however, the industry will have to stop "dissipating our efforts through fragmented initiatives," according to Mr. Senterfitt. More than banking unity will be needed, he added.

"Let's stop funding our enemies in Congress, the ones who damn us with faint praise and the ones who oppose us openly," he said. Let's stop ignoring our friends, even when we find them in someone else's state or congressional district. I challenge our Washington staff to do more to identify who our friends are and who our enemies are — and to let us know."

When bankers give political support, either individually or through ABA's BankPac, they are entitled to support in return, said Mr. Senterfitt.

"We have got to draw out latent sentiment in the Sentate and House of Representatives for the very things bankers want for their customers," he said. "That will take some skill, but we can do it."

Former MCB Publisher Dies

JAMES J. WENGERT, former publisher of MID-CONTINENT BANKER, died in Cedar Rapids, Ia., on October 20 at the age of 86.

Mr. Wengert retired as publisher of MID-CONTINENT BANKER in 1967 after having been associated with the magazine for more than 42 years. He was succeeded by the late Harold R. Colbert, who in turn was succeeded by Ralph B. Cox. Mr. Cox retired as publisher of MID-CONTINENT BANKER in July, 1985.

At the time of his retirement, Mr. Wengert also was chairman/CEO of Commerce Publishing Co., the firm which publishes MID-CONTINENT BANKER and four other trade magazines: *Life Insurance Selling*, *American Agent and Broker*, *Club Management* and *Decor*.

MID-CONTINENT BANKER, founded in 1904 and purchased by Donald H. Clark in 1923, was the first of the Commerce Publishing Co. magazines. In 1925, Messrs. Clark and Wengert founded *Life Insurance Selling*, a publication devoted to sales and marketing ideas in the life insurance business. In 1929, Messrs. Clark and Wengert — along with Harold Colbert, who had joined the firm in that year — founded a publication for the property-and-casualty insurance field called *The Local Agent*, a magazine that later was retitled *American Agent and Broker*.

Robert L. Clarke, Comptroller of the Currency, didn't show the tough-as-nails determination Mr. Senterfitt exuded in his presentation, but he echoed Mr. Senterfitt's "bankers-can-do-it" theme.

"You can either shape your destiny or you can allow it to be shaped for you by failing to respond to the emerging reality of the global financial marketplace," said Mr. Clarke. Citing General Motors Acceptance Corp.'s sale of $4 billion in securities backed by auto loans and the deregulation of the financial markets in London (the so-called "big bang" which took place the week of the ABA convention) as evidence of the trend toward globalization of financial markets, Mr. Clarke noted that the effects of that trend will not show up with a great deal of fanfare. Rather, the effects of internationalization will "trickle down into your bread-and-butter markets," he said.

"My concern — as a public official charged with maintaining the safety and soundness of the American banking system — is to ensure that our banking structure enhances the international competitiveness of U. S. banks in the global arena," said Mr. Clarke. "My concern is to ensure that our banking structure is equipped to meet the competition."

Mr. Clarke said that he is concerned that only one U. S. bank is among the world's 10 largest and that a Japanese bank can propose to become a partner in an American securities firm while American banks are limited in the types of securities activities they can engage in.

"I am concerned that our banking system is not equipped to beat the competition when an American bank can do things in London or Tokyo that it is prohibited from doing in the United States," he said.

Present banking law in the U. S. weakens the banking system, said Mr. Clarke. "For American banking to be preserved, these laws must be changed."

"In light of the global competition," he continued, "we must ask ourselves: what kind of financial structure do we need? We must ask: What kind of regulatory structure do we need? We must ask: Is there a place in the financial structure for institutions that are specialized by law — especially if these institutions are favored in government policy?"

Incoming President Mark W. Olson, president, Security State, Fergus Falls, Minn., said the banking industry must build on its strengths which come from the diversity and geographic distribution of financial institutions.

"To this day, the U. S. banking system remains a system characterized by that phenomenon of decentralization," he said. "Take any other country and the distinction is immediately clear. France has a little over 400 banks. Germany has about 240; Canada 10; Japan roughly 85; the United Kingdom 290."

With 14,300 banks and thousands of branches, banks have become the custodians of the nation's payments system and the premier providers of its capital needs, said Mr. Olson. In addition, banks have come to participate actively in the economic health and welfare of the communities they serve.

"I believe we can say in confidence that no industry in this country has matched — and no industry can match — the commitment of human and financial resources that the banking industry has made to the economic health and the civic well-being of the 55,000 U. S. communities that banks serve," according to Mr. Olson. "I only wish the future could hold such promise."

Community banks are not immune to the competitive inequities that exist for banks, Mr. Olson said.

"All of us remember the days when we could beat the auto industry's affiliates in making new car loans," he continued. "Four or five years ago when those affiliates began using lower rates to stimulate sales, the market dried up for many of us. We expected it would come back, but with the practice of packaging car loans for later sale as securities — something banks can't do — we may never have access to that market again."

In addition to Mr. Olson, other ABA officers elected and inducted at the convention were: Charles Pistor, chairman/CEO, RepublicBank, Dallas, new president-elect, and Thomas P. Rideout, senior vice president/director-governmental affairs, First Union Corp., Charlotte, N. C., returning for a second term as treasurer.

Securitization *(Con't.)*

12 of which are active, according to the SBA. In fiscal 1986 (the first year of the SBA pooling program), a total of $321 million of the $1.9 billion in SBA loans outstanding have been pooled.

Although the SBA is guaranteed funding through fiscal 1987-'88, the agency could come under pressure to cut back or dissolve as it did earlier this year, Mr. Pipp concedes, yet he doubts that investors holding SBA loan-pool certificates would be adversely affected even if the SBA were dissolved. Guarantees on existing loans would have to be grandfathered and, while there might be decline in liquidity for such securities, investors possibly would be compensated by an appreciation in the scarcity value of securities backed by SBA loans, he says.

Mortgage-Back Securities

While financial institutions continue to experiment with securities backed by new types of assets, the mortgage-backed securities market has hardly been static. For example, Roger F. McMahon, executive vice president, Securities Trading Systems, Inc./RMJ Securities, Inc., New York, estimates that the market in CMOs has grown from approximately $4 billion in 1983 — the year CMOs were introduced — to more than $70 billion this year.

Investors didn't quite know what to make of CMOs at the time of the first Federal Home Loan Mortgage Corp., private placement on June 7, 1983, Mr. McMahon says. Ultimately, investors came to appreciate the call-protection features of the CMOs, and this year the market has exploded, he says. He expects the market for other new asset-backed securities to follow a similar pattern — introduction followed by a period of slow growth as investors gain experience with them and then a period of rapid growth once the new securities have been accepted. • •

Perspective *(Continued)*

petition probably will force banks to become more aggressive in pooling loans and selling them off in the form of securities. A federal agency similar to Fannie Mae could arise to assist in pooling the assets of ag banks and enhancing them for resale. Money-center and regional banks will continue to explore means of pooling their own assets and those of their respondents for resale. Investment banks such as First Boston and Salomon Brothers will continue to prosper as underwriters of these new securities. Eventually, the money-center and regional banks may find ways around the regulations to become more active as underwriters of debt securities.

Beyond this, not much is certain. Who can say what new types of debt instruments will emerge from the maw of the huge securities-creation mechanism that has been set in motion? The mortgage-backed securities market hardly has remained stagnant since it took off in the early 1970s. If you were just getting comfortable with the concept of the CMO — a market that has grown to $70 billion in the less than four years since their introduction — prepare yourself for the REMIC (real estate mortgage investment conduit) coming your way January 1 courtesy of the new tax-reform package President Reagan signed into law late last month.

In addition to the implications for the nation's economy, the Federal Reserve's ability to control the money supply and the other questions raised in Mr. Bryan's article, a host of bank-management issues are related to securitization. A complete rethinking of the principles of asset/liability management would seemingly be in order in a world in which banks book loans primarily for resale by another entity. Can depository institutions squeeze enough profits out of transaction and servicing fees to remain viable in a world in which they act merely as brokers? By what standards do financial institutions judge the new debt securities from an investment perspective? Is the banking industry's investment in brick and mortar really the waste the investment banker quoted earlier suggests? After all, someone has to produce the raw material from which debt securities are forged, and it's difficult to believe that all borrowing will be done electronically in the future.

These are some of the questions related to securitization that the banking industry is just beginning to grapple with. Dr. Gerald Fischer, RMA consultant currently engaged in securitization research, says that answers to some of these questions should begin to emerge from the ABA/RMA/McKinsey studies within the next year. Voluntary guidelines bankers can follow in packaging assets for resale and judging the credit quality of new debt security issues should be ready by early 1987 with a comprehensive report on securitization due later in the year.

For the banking industry, those answers can't come too soon.

— John L. Cleveland
Editor/Associate Publisher

Ag-Bank Marketing

A good marketing program is one of the best tools to avoid farm loan problems

By David R. Breeze

OPPORTUNITIES exist for new ag business today. In fact, opportunities have never been greater since my farm-credit experience began 20 years ago!

It's no secret that ag banks must maintain quality portfolios in this difficult economic transition period. To do this, they must have adequate loan supervision. But they also must have marketing programs that enable bankers to counsel and guide farmers who will not survive off the farm as well as serve to replenish the bank's loan portfolio with high-quality new business.

These new loans can be obtained through an active calling program that takes the banker to the farmer's place of business.

Because my $120-million-asset bank has developed an aggressive marketing posture that seeks the best loans, it is able to serve agriculture and maintain top earning assets. In the past 10 months, my bank has added 18 quality farm customers to its portfolio of 320 farm customers. Unfortunately, that number represents less than one-third of the applicants for such loans.

A sound marketing program requires devotion of time to business development and creation of a selling environment on the part of bank employees. Such a program breaks tradition since it doesn't consider waiting for customers to come to the bank. Those days are gone forever. The only business coming in the bank's front door today is the business nobody wants.

The modern bank must perform better than any other financial institution does.

Tools of a professional ag lender include the following: double-column balance sheets, projected profit-and-loss statements, cash flows, trend analyses, farm-business-structure analyses with information provided on microcomputers, partial budgets and strong loan supervision coupled with on-the-farm credit counseling.

Lenders must encourage farm customers to do better at financial planning. They must be good listeners and work in partnership with customers in an effort to help them achieve their financial goals.

Farmers sometimes have to be sold on the merits of scaling down their operation, a task that requires a great deal of skill. Since 1980, 39 of our farm customers have sold more than 5,000 acres of land to outside investors or neighbors. This action has kept them from experiencing serious financial trouble today.

Our objective should be to be professional lenders, not just note takers or collateral lenders. I like to think of myself as a profitability lender and my goal is to extend sound credit in the best interests of my bank's farm customers.

Good marketing involves attitudes. Selling requires an aptitude as well as an attitude. I try to emphasize the consultive-selling approach, which determines the most effective way to meet the prospective customer's needs. I consider myself to be a problem solver in the people business.

Marketing actually may be the real key to credit quality — as a solution to loan problems, not their cause. But it takes disciplined marketing to avoid the pitfalls of what is considered marketing by those who are not acquainted with marketing skills. Good marketing demands a high degree of professionalism, thorough research and

Mr. Breeze is vice president/ag lending at First Trust & Savings Bank, Taylorville, Ill.

analysis. Marketing is a strategic response to the bank's mission and objectives, and, as such, is compatible with each. It's a lack of an effective marketing discipline that has resulted in problem loans, charge-offs and bank failures.

The ideal bank-customer relationship is one in which the customer depends on the banker. When I speak of building relationships, I mean finding ways as marketers to increase this reliance. I want my customer to do all his business with my bank. I want my customer to turn to me first when he has a financial question or need. I want my customer to use my bank's services to the exclusion of those of its competitors. I want my customer to consult with me on a financial decision before he buys a combine or a tract of land.

It takes prospect calling to build business. There's no substitute for it. When calling on prospects, don't sell interest rates, sell service and then deliver it.

Ask these questions when evaluating sales efforts: "How well sold was the customer?" "Why did the customer come to my bank?" The loan committee is especially interested in answers to these questions.

The farm department at my bank develops a top-50 prospect list that is updated every six months. The entire staff concentrates on suggesting farmers for this list. One way we reach these prospects is through our existing customers. We harness some of our key customers to help build business for the bank, somewhat in the way the Farm Credit System uses its advisory committee to bring in new business.

I use the telephone to make appointments with prospects. Part of our prospect file is a diary that provides the information we need about prospects. Selling aides include brochures, business cards and limited newspaper advertising.

An ag representative who uses fewer than 150 business cards a year isn't calling on enough people.

Farmers — like everyone — like to do business with people who act as though they care about them. We let our customers know we care by taking an interest in their operations, remembering them on anniversaries and sending thank-you notes after calling on them. We also keep in mind the question: "What does this farmer want from my bank?"

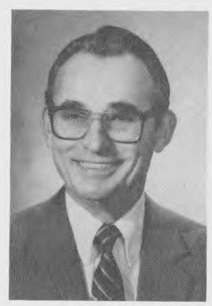
What he wants is security and survival. A banker can't offer these qualities convincingly if he doesn't know his financial institution. Keep a list of services the bank offers and refer to it when discussing a farmer's situation.

The true measure of leadership at any level of business activity is the capacity of the banker to be sensitive and understanding of the basic needs of farmers. Establishment of this understanding is a rewarding human experience and it bears fruit.

Bankers' efforts to guide their customers through troubled times will test one's abilities to remain at the farmer's side through good and bad times. Bankers must be as flexible, innovative and courageous as their farm customers for, in the end, the test is ours, too! ● ●

If bankers study and listen to their customers' needs, they can become better salesmen and will appreciate their work and themselves better.

● **Two former** mid-continent-area bankers have joined the senior-advisor group of Golembe Associates, Inc., Washington, D. C. They are James E.



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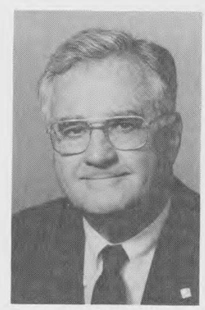

KENNEDY

Brown, former president, Mercantile Trust, St. Louis, and William H. Kennedy Jr., former chairman/CEO, National Bank of Commerce, Pine Bluff, Ark. They serve as advisors to senior management at Golembe.

● **James D. Rode** has been elected chairman of the Consumer Bankers Association. He is president, AmeriTrust Co., Cleveland. Among board members elected are William C. Nelson, executive vice president, InterFirst Bank Dallas, and Jack H. Shipman, executive vice president, Liberty National, Louisville.

Knowing Your Regulators

Statements of regulators and attorneys defending banks against regulatory actions provide contrasting views of regulator intent

By Jim Fabian
Senior Editor

FEDERAL regulators are concerned that banks are making limited use of FASB-15, that troubled banks are not maintaining adequate loan-loss reserves and that they are not pleased when they "discover" a bank's problems rather than be informed about them prior to an examination.

A panel of regulators discussed their concerns at the recent annual convention of the Iowa Bankers Association in Des Moines. Representatives of federal regulators included Charles Thacker, regional director, FDIC, Kansas City; Robert Klinzing, deputy comptroller, Office of Comptroller of the Currency; and James Morrison, senior vice president, Chicago Fed. Also on the panel was William Bernau, Iowa's superintendent of banking.

Mr. Thacker said bankers don't understand FASB-15 and they think it won't help farmers with their debt problems. On the other hand, he said many bankers are performing interest restructuring, although not using FASB-15 guidelines. The FDIC is hoping that FASB-15 will be used more in the future.

Mr. Thacker also told bankers that capital-forbearance participations are significantly small and most banks applying are those that don't qualify due to technical insolvency. He reminded his audience that the program is designed for ag banks that can work out their problems over time. An informal corrective program that requires capital maintenance is being used instead of capital forbearance in some cases, he said. This program serves as a type of capital forbearance. He stressed that capital forbearance isn't window dressing and it is being granted to qualified applicants.

He said that failure of troubled banks to maintain adequate loan-loss reserves is a "serious management deficiency" when capital forbearance is available. Banks not maintaining adequate loan-loss reserves usually don't have watch systems to help them establish proper loan-loss reserves.

The typical problem bank has a moderate volume of serious weaknesses, he said, and these weaknesses usually aren't being addressed in a satisfactory manner by bank managements. These banks have excessive volumes of classified assets and declining earnings and their oversight policies are ineffective. These banks are given Camel ratings of four or five.

He admitted that the examiner shortage is rife in the Kansas City region. Some 45% of problem banks on the FDIC's list haven't been examined in the last 12 months. About one-third of the examining force has been on the job less than 18 months. One bright spot: The agency is hiring what it terms

Panelists representing regulators at "Know Your Regulator" session at Iowa Bankers Association convention included (from l.) William Bernau, Iowa banking supervisor; Charles Thacker, FDIC; Robert Klinzing, Comptroller of the Currency; and James Morrison, Chicago Fed.

the "cream of the crop" of recent college graduates, many of whom have ag bankgrounds.

Mr. Klinzing of the Comptroller's office declared that his agency wants to help bankers, not put them out of business. But it doesn't help when the agency discovers a bank's problems. It would prefer to be told about these problems in advance of examinations.

The goal of a memo of understanding is to try to identify a problem and reach an agreement to solve it. Regulators want to be assured that banks have formulated plans to manage their problems. They consider such plans as road maps that lead to solutions and solvency.

Mr. Klinzing advised bankers not to get hung up on matters of form; rather, they should deal with matters of substance. He added that his representatives are willing to discuss and even change the wording of memos of understanding. He decried the disproportionate number of arguments over matters of form. Often bankers have an attorney represent them and the attorney turns a discussion into a confrontation. Why pay a high-priced attorney to get concessions for the bank that could have been obtained at no cost through discussions between banker and regulator, he asked.

Mr. Klinzing's final recommendation about attorneys was addressed the next day at another special-interest seminar — one featuring an attorney from Minneapolis. The title of the session was "Controlling Your Regulator When Push Comes to Shove."

The Comptroller and the FDIC have no legal authority to force a bank to charge off any loans. This situation gives the agencies problems of enforcement.

Mary Curtain with Lindquist & Vennum, Minneapolis, stressed the importance of knowing when a bank needs assistance in the face of regulatory action.

She explained that a memo of understanding is not legally enforceable, but that a written agreement is quasi enforceable. A violation of the latter can result in a cease and desist order and violation is similar to a breach of contract.

She strongly advised bankers not to sign a cease and desist order before its contents are understood. She added that bankers should not sign a capital provision in a cease and desist order unless it places a specific capital requirement on the bank, such as 7%, including loan-loss reserves.

In the area of bank management, Ms. Curtin said the FDIC wants to remove incompetents even though it has no legal authority to do so without taking an involved series of steps. She said the FDIC will ask a bank to give the agency the right to remove individuals in management positions. Never sign such a document, she advised, because doing so removes liability from the FDIC. Such provisions have been litigated four times, with the agency losing each time, she said. Yet the agency continues to use this practice in an attempt to find out if bankers involved know such a practice can't be used!

"The FDIC's authority consists of that which the banker gives it," Ms. Curtain said.

A problem national banks have with the Comptroller is that the Comptroller wants banks to act on preliminary reports rather than the final report. The final report could be different from the preliminary report, she said, because it reflects review from headquarters while the preliminary report contains only the examiner's views.

The Comptroller and the FDIC have no legal authority to force a bank to charge off any loans, Ms. Curtain claimed. This situation gives the agencies problems of enforcement.

The Comptroller uses call reports to determine if an on-site examination is necessary. Thus, she said, the practice is only as good as the information submitted on call reports. And call reports are required to reflect management's assessment of the bank's condition, not regulator's assessments.

The Comptroller's office doesn't want banks to question the views of its examiners, Ms. Curtain said. She advised bankers not to change the call report if the bank receives a preliminary classification just before the call report is submitted to the Comptroller. "Say you didn't receive it before the report went out," she advised. Changing the report to conform to the examiner's preliminary classification would indicate that the report reflects the examiner's views, not bank management's.

If management feels an examiner is wrong in his classifications, management should confront the examiner with the facts, Ms. Curtain said. She gave an illustration of a bank that went from 75% classified loans to 250% in a period of six months. The huge change reflected the views of a new examiner.

Should a bank decide to litigate against its regulator, it shouldn't do it on a basis of principle, she said. "Do it only if the cost of litigation is less than the cost of not litigating." • •

Bankers, Regulators Consider Interstate-Banking's Effects

BANKING regulators gave differing predictions as to the landscape of banking five years from now at the annual bank seminar of Peat Marwick's St. Louis office, held recently.

"Practically nationwide interstate banking" was predicted by Delmer D. Weisz, vice president of the Federal Reserve Bank of St. Louis.

Similarly, James D. Martin, Illinois Deputy Commissioner of Banks and Trust Companies, expects "probably another attempt to a national trigger in Springfield" within the next five years.

On the other hand, Thomas B. Fitzsimmons, Missouri Commissioner of Finance, does not expect nationwide banking quite that fast. Congress is leaving the question of nationwide banking to the states and the presently emerging banking regions may not be ready for nationwide banking in five years.

The effects of interstate banking primarily will be seen in the major urban areas, said Mr. Fitzsimmons. "I don't think we're going to bring capital into the rural areas. The bigger players want to play in the areas they're most familiar with and that's the metro areas."

Most bankers at the seminar were not worried about the future effects of interstate banking. A survey question asked the 200 attendees, "How do you view the impact of regional interstate banking on your bank?" The responses were 45% positive, 17% negative and 38% neutral.

A few years ago, the negative response was much higher, according to J. Alan Harkness, partner in charge of the St. Louis office of Peat Marwick.

In addition, 77% of the attendees reported that they expect money-center banks to have a significant influence in the Missouri-Illinois-Kentucky banking markets within five years.

About half of the bankers were from Illinois and half from Missouri, and 80% were from banks of less than $200 million in assets. • •

Bank Credit-Management Practices Need Updating, Says Consultant

TRADITIONAL credit-management practices no longer are valid because they're not solving today's problems, said Stephen W. Rich, senior manager, Peat Marwick, St. Louis, at a recent seminar for bankers.

Competitive factors are forcing banks to "down market" their lending efforts in order to find the customers they seek. This means they often must lend to new industries in an expanding geographical market. Often these industries and markets are ones bankers are not comfortable with because they are unfamiliar, Mr. Rich said.

Deflation also is a factor because it impedes repayment ability of borrowers. This factor is a new experience to many bankers whose mind-set has been keyed to continuing inflation.

Loan growth is rapid, he said, which means banks are taking more risks. These risks increasingly are showing up in categories thought to have been relatively risk free in the past.

Mergers among banks are another factor calling for enlightened credit-management policies. Mergers are likely to create unanticipated problems that are not covered by existing policies.

Although loan approval by committee still is common, it is becoming increasingly detrimental to credit quality, Mr. Rich said. Yet a more unstructured approval process also can be dangerous because of an increasingly lack of staff "seasoning" created by higher staff turnover.

The result is a vicious cycle caused by shareholders and directors putting pressure on management for a higher bottom line that cannot be achieved because of an outdated credit-management policy.

Strategic/Credit Planning Vital

Strategic and credit planning are necessary for a solution to this situation, Mr. Rich said. Strategic planning can set direction for the portfolio and itemize risks to be taken. Credit planning can take into account risks and growth desired.

Portfolio-acquisition policy must take into consideration business-development goals; proper credit analysis; policies for structure and negotiation; loan approval and documentation; and booking, closing and disbursement.

Portfolio maintenance is vital to ensure good loan performance, Mr. Rich said. Customer relationships must be managed in such a way that problems are quickly identified through contact with customers and by portfolio analysis through loan review.

Credit management should combine up-front planning, an efficient delivery system and portfolio monitoring. It should be information drivern and be adjustable, he said. ● ●

D&O *(Continued)*

deductibles when making application for D&O, Dr. Austin says. Applications should indicate that the bank has an effective risk-control policy that includes a loan-review program and codes of conduct for directors and officers.

Most carriers issue one-year policies now, rather than the traditional three-year policies, Dr. Austin says.

It's not unusual for a bank to have its policy cancelled for one reason or another, including the underwriter getting out of the D&O-coverage business. It's imperative that a bank that has its D&O coverage cancelled make efforts to find another carrier, Dr. Austin says.

Carriers are tightening qualifications for banks seeking D&O coverage, often making demands that are out of the ordinary, Dr. Austin says. He adds that bank managements should realize they are not permitted to give carriers copies of examination reports or to allow carriers to inspect the reports unless regulators specifically authorize such action. ● ●

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WESLEY H. CLARK, *Publisher*

NEW PRODUCTS/SERVICES

Use the Reader Inquiry Service on facing page to obtain further information about the products reviewed on this page.

• **1st Financial Video Network** has released "Supervisory & Management," a videotape training program for establishing effective relationships with employees. Four training modules deal with communication skills, time management, goal setting and performance appraisal.

For information, circle 101

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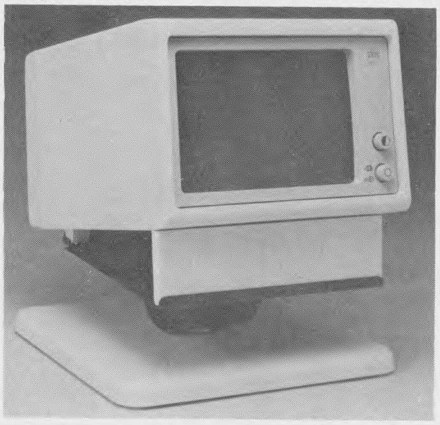
• **A tilt/swivel stand** for IBM 4704 financial terminals is available from Ergotron, Inc. The stands are said to



relieve operator stress, reduce glare and improve viewing comfort. They have tilt and rotation capability.

For information, circle 102

* * *

• **A software product** to simplify handling of NSF and return items is available from Information Technology Inc. It's called "On-line NSF/Return Item Module" and is said to improve both the quality and timeliness of pay or return decisions on NSF items.

For information, circle 103

* * *

• **A new student loan** accounting system is available from Norcom. Its three modules include loan origination, interim student-loan accounting with student PLUS and repayment student-loan accounting with parent PLUS. Modules can be operated independently or as an integrated unit.

For information, circle 104

* * *

• **A new farm record-keeping-service** software package called "AgCHEK Service" has been introduced by Doane Publishing. It allows banks, accountants, farm-management consultants and others to set up a service center to provide financial record-keeping and produce financial reports for farmers.

For information, circle 105

* * *

• **A new illuminated awnings system** has been introduced by Federal Sign Corp. It allows banks to repackage the look of their premises with a tear resistant, translucent and fade-resistant fabric awning that's custom fitted at the factory.

For information, circle 106

* * *

• **A new spread sheet** for commercial lending trend and ratio analysis is available from Robert Morris Associates. Form C-112 comes in 5- and 12-column formats and allows space to display dollar amounts and percentages.

For information, circle 107

* * *

• **A new software development,** named "Collector," is available from SecureData Corp. to aid credit processors in managing and collecting delinquent funds. It enables accounts to be worked in priority sequence automatically.

For information, circle 108

* * *

• **"A Practical Guide to the Law of Secured Lending"** is available from Prentice-Hall, Inc., that offers legal answers, solves problems and minimizes risks in the negotiation, drafting and implementation of secured-credit transactions.

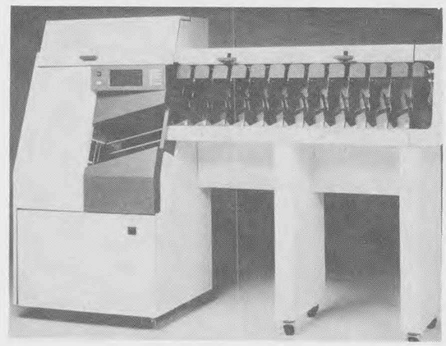
For information, circle 109

* * *

• **A policies and procedures guide** for real-estate lenders has been published by MCS Associates. The guide provides guidance in loan origination, from application through closing. The set includes four books and two volumes of sample forms covering single-family residential permanent loans, construction loans, permanent lending on income property and purchase of mortgage loans.

For information, circle 110

• **NCR** has introduced its 6760 Tower-Check system for medium-sized banks that process up to 100,000 items daily. Features include self-contained intelligence and a processing speed of up to 1,000 documents per minute. Hardware options include a microfilmer unit, alphanumeric ink-jet endorsers, a positional roll-on endorser



and an auxiliary plasma display for multiple-pocket module configurations.

For information, circle 111

* * *

• **New video training programs** for lenders are available from Bankers Training & Consulting Co. They are: "Collecting Consumer Loans," "Would You Make This Loan — A Case Study" and "Lessons From Loan Workouts."

For information, circle 112

* * *

• **An on-line loan application** processing system for IBM mainframe computers is available from Anacomp, Inc. "The BankServ Application Processing System" is designed to improve productivity, reduce paper usage, assure uniform credit decisions and improve customer service.

For information, circle 113

* * *

• **Banks can place** orders for loan-payment books via diskette input to Bank-A-Count Corp. The firm accepts a bank's existing diskette format or provides specifications for its own preferred format. Payment books are shipped the same day as the order input is received.

For information, circle 114

Reader Response Page

November, 1986

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B. [] $500 Million-$1 Billion
C. [] $250-499 Million
D. [] $100-249 Million
E. [] $50-99 Million
F. [] Under $50 Million

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Third National Bank, Nashville	30-31	33
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Coming Events

Nov. 16-19: **BAI ATM9, Electronic Delivery Systems Conference,** Bonaventure Hotel, Los Angeles.

Nov. 16-19: **BMA Trust and Personal Financial Services Marketing Conference,** Sheraton New Orleans Hotel.

Nov. 16-19: **ABA National Ag Bankers Conference,** Opryland Hotel, Nashville.

Dec. 3: **NACHA Corporate Cash Management Seminar,** Airport Sheraton Grand Hotel, Dallas.

Jan. 27-30 **ABA National Security and Risk Management Conference,** Sheraton Harbor Hotel, San Diego.

Feb. 15-18: **BMA Community Bank CEO Seminar,** Marriott's Mountain Shadow Resort, Scottsdale, AZ.

Feb. 22-25: **BMA Electronic Banking Product Strategies Conference,** Phoenix Hilton.

March 8-11: **ABA National Conference for Community Bankers,** Hyatt Regency and Hilton, Phoenix.

March 15-18: **NACHA Annual Conference,** Intercontinental Hotel, San Diego.

April 1-5: **Independent Bankers Association of America Convention,** Marriott's Orlando World Center.

April 9-12: **Louisiana Bankers Association Convention,** New Orleans Hilton.

May 7-9: **Oklahoma Bankers Association Convention,** Shangri-La Resort, Afton.

May 11-14: **Alabama Bankers Association Convention,** Colonial Williamsburg, Williamsburg, VA.

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