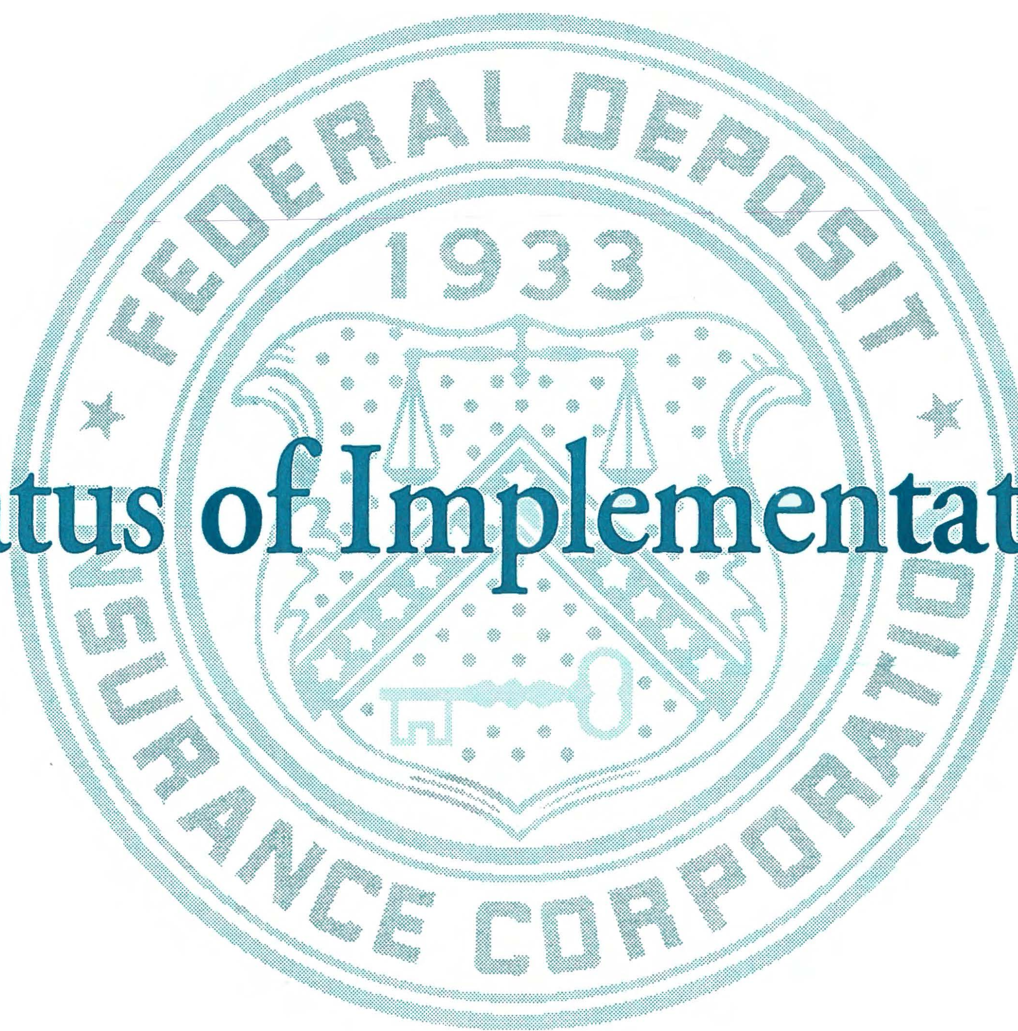
FDIC IMPROVEMENT ACT Handbook



Status of Implementation

DIVISION OF SUPERVISION
Federal Deposit Insurance Corporation
December, 1993

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Introduction

On December 19, 1991, the FDIC Improvement Act (FDICIA) was signed into law, creating major changes in the regulation and supervision of insured depository institutions. It requires the federal regulatory agencies to issue a host of new regulations. The FDICIA Handbook has been prepared by the FDIC Division of Supervision and is intended to be a status report on selected provisions in FDICIA of interest to bank examiners. It is not a comprehensive summary of all of FDICIA.

This publication consists of a series of papers on the major provisions in FDICIA that describe the purpose of the law, give a summary of the implementing regulation or other guidance, and provide an analysis of the impact on FDIC activities, the status of the rule and a FDIC contact for further information. Summaries generally include questions and answers about the provision.

The Rulemaking Process

The decision to issue a regulation may be prompted by a statutory requirement or initiated by the agency due to a desire

to provide guidance in a particular area. FDICIA requires the federal financial institutions regulatory agencies to issue rules that cover many of its provisions. On others the FDIC has issued non-regulatory policy statements or guidance for implementation. All proposed rules must be approved by the FDIC Board at the proposed and final rule stages.

On rare occasions a proposal may first take the form of an **Advance Notice of Proposed Rulemaking** (ANPR). An ANPR seeks guidance on whether a rule is needed in a particular area and asks questions about how such a rule might be written. Based on the response from the public and on other factors, such as statutory requirements, an agency may then decide to issue a proposed rule. An ANPR contains no regulatory language.

For most rules, the process begins when the agency publishes a **Notice of Proposed Rulemaking** (NPR) that describes what the agency proposes to do and provides an opportunity for the public to comment. It will contain proposed regulatory language and a preamble which discusses the reasoning and questions that support it.

To make sure that affected institutions have every opportunity to comment on proposals, FDIC sends Financial Institution

Letters with the text of proposed rules to affected regulated institutions and to examiners. A press release will also inform the general public. While interested parties find this helpful, the number of proposed rules in 1992 and 1993 has created an absorption burden.

Once the public comment period has ended, FDIC staff reviews the comment letters. The number of comment letters range from two or three on some rules to hundreds and even thousands on controversial issues. Based on the comments, the FDIC may decide to revise the proposal. If the revisions are major, the FDIC can publish a new proposed rule for further comment. If not, the FDIC will incorporate the changes into a **Final Rule,** which must again be approved by the FDIC Board before being published in the Federal Register.

The final rule will contain the formal regulatory text, together with a preamble that discusses the comments and agency reaction to them and the reasons for changes to the original proposal. Readers should not ignore these preambles. They are an important source of explanation of the intent, meaning and purpose of the regulation. The preamble will often answer the question about what is missing from the regulation and why.

The process of issuing a rule can take from several months to over a year. Writing the FDICIA rules has been more involved because many of the rules are being issued jointly by the Office of the Comptroller of the Currency, FDIC, Federal Reserve, and Office of Thrift Supervision.

Contact

The information in FDICIA Handbook is intended to help you understand the current status of FDICIA rules and how those rules will affect FDIC's supervision activities. For more detailed information about the specific provisions of FDICIA field personnel usually should contact their regional office. Each section also lists the Washington office, Division of Supervision or Legal Division staff member most knowledgeable about the subject.

This handbook was prepared by the FDIC's Division of Supervision for the exclusive use of its examiners. The opinions expressed herein represent the current thinking of the staff of the Division of Supervision and, as such, are not binding upon the FDIC or its Board of Directors. The statements in this handbook are not intended to be, nor should they be construed as, legal opinions.

EXAMINATION FREQUENCY

Policy

Purpose

Section 111 of FDICIA amends section 10 of the FDI Act to require annual fullscope onsite examinations of all insured depository institutions including state-licensed insured branches of foreign banks.

Summary

Acceptable State Examinations - Examinations conducted in alternate 12 (or 18) month periods by the appropriate state supervisory authority may fulfill the federal requirement provided that the appropriate federal banking agency determines that the state examination carries out the purpose of the law.

Small Institutions - An 18 month examination interval can be substituted for the 12 month interval if:

- the insured institution has total assets of less than $100,000,000;
- the institution is well capitalized as defined in section 38;
- when the institution was most recently examined, it was found to be well-managed and its composite condition was found to be outstanding (the four federal banking agencies have agreed that the institution must be a composite 1- rated institution to meet this requirement);
- no person acquired control of the institution during the 12 month period in which a fullscope onsite examination would be required but for this paragraph.

Exemptions - Conservatorships and bridge banks are exempt from the examination requirement. Consumer compliance examinations are not included in the term "fullscope, onsite examination" on the frequency requirements as used in this section.

Effective Date and Transition Rule - This amendment became effective on December 19, 1992. However, a transition rule is effective until December 31, 1993. The transition rule permits an 18-month examination cycle for all institutions unless the institution was found to be in less than satisfactory condition (i.e. rated 3, 4 or 5) at the most recent examination or one or more persons acquired control of the institution.

Contact

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Questions and Answers

Q. How is the 12 and 18 month examination cycle calculated?

A. For scheduling purposes, the 12 (or 18) month examination cycle is taken to mean that no more than 12 (or 18) months may elapse between the end of one examination and the beginning of the next examination. "Examination date" will be the date the examination commenced and not the financial statement "as of" date. The "examination completion date" is the earlier of: (a) the day the examiner leaves the bank; or (b) 60 calendar days from the examination date.

Q. How is a fullscope examination defined?

A. The FDIC considers Tier I or Tier II examinations to be fullscope

examinations although the distinction is blurring and will be settling closer to the former Tier I concept.

Q. When are State examinations acceptable for extending FDIC examination cycles?

A. The FDIC policy is to conduct alternate examinations with appropriate state authorities for composite 1- and 2- rated institutions and for stable and improving 3-rated institutions. The state examinations must be acceptable to the FDIC and the rating must be confirmed by the CAEL off-site monitoring system with no adverse trends noted from other available information.

Q. Does a fullscope examination have to be conducted for every bank affiliate of a multi-bank holding company?

A. Yes. FDICIA requires an examination of all insured depository institutions every 12 or 18 months with no exceptions.

AUDITS AND REPORTING

Final Rule

Purpose

Section 112 of FDICIA adds section 36 to the FDI Act. It establishes new audit, reporting, and audit committee requirements for certain insured depository institutions for fiscal years beginning after December 31, 1992. These requirements are designed to facilitate early identification of problems in the financial management of depository institutions.

Summary

New FDIC regulation Part 363 and Appendix A -- Guidelines and Interpretations implement the new statutory requirements contained in section 36 of the FDI Act effective July 2, 1992. Part 363 applies to all FDIC-insured institutions with total assets of $500 million or more, regardless of primary supervisor. They must have an annual independent audit and file an annual report with the FDIC and the appropriate federal and state banking agency. The annual report must consist of:

- Audited annual financial statements;
- Audit report;
- Management's statement of its: (a) responsibility for the financial statements, an adequate internal control system for financial reporting, and compliance with designated safety and soundness laws and regulations; and (b) assessment of the effectiveness of the internal controls for financial reporting and the institution's compliance with designated safety and soundness laws and regulations; and
- Independent public accountant's attestation report on management's

assertions concerning the effectiveness of the institution's system of internal controls over financial reporting.

The annual report must be publicly available, preferably at the institution, but also at the regional office.

The independent public accountant must perform procedures listed in Appendix A to Part 363 to test compliance with the designated safety and soundness laws and regulations. These designated laws and regulations are those concerning insider transactions and dividend restrictions.

Institutions with assets of $500 million or more are required to have an independent audit committee composed entirely of outside directors. Audit committees in institutions with assets exceeding $3 billion also must:

- Include at least two members who have banking or financial management expertise;
- Exclude outside directors who are large customers of the institution; and,
- Have access to their own outside counsel, independent of management.

The annual audit requirements may be satisfied for institutions that are subsidiaries of a holding company by an audit of the holding company's consolidated financial statements. A separate audit of each subsidiary institution's financial statements is not required. All other reporting and audit committee requirements relating to this section may be satisfied at the holding company level, provided:

- The services and functions comparable to those required are provided at the holding company level;

- The institution provides copies of the holding company's reports required by this section to the FDIC; and,
- The institution has assets of less than $5 billion, or of between $5 billion and $9 billion with a composite CAMEL rating of 1 or 2.

Each institution covered by this section must provide to its external auditor a copy of its most recent examination report and any other supervisory memoranda or other written agreements between the institution and its federal and state supervisory agency.

Each institution must file copies of any audit report, management letter, or other report from its independent public accountant with the FDIC and other agencies within 15 days of receipt. The institution must notify the FDIC and appropriate federal banking agency of the resignation or dismissal and selection of a new independent public accountant within 15 calendar days of the event. The accountant who has resigned or been dismissed must also notify the FDIC within 15 days of the reasons for the resignation or dismissal. Independent public accountants must provide to the FDIC, upon request, working papers, policies, and procedures relating to its audit services for the institution. The agencies also may remove, suspend, or bar an independent public accountant for cause from providing audit services required by the statute.

Effect on FDIC Operations

The information contained in the required submitted reports will be incorporated into the supervisory process and will be helpful in determining the timing and scope of examination. The FDIC issued regulations apply to all types of institutions, but the primary federal regulator is responsible for any enforcement action.

The introduction to the guidelines encourages every depository institution, regardless of size or charter, to voluntarily have an annual audit of its financial statements by independent public accountant and establish an independent audit committee.

Sources

FIL-67-92 (9-21-92)	Proposal to Implement Law Requiring Annual Audits, New Reporting Requirements (Part 363)
FIL-94-92 (12-28-92)	Interim Guidance Concerning Annual Audits, New Reporting Requirements (Part 363)
PR-49-93 (5-11-93)	FDIC Adopts Final Rule Implementing Statutory Requirements for Outside Audits of Insured Banks and Thrifts, Other Safety Measures
FIL-41-93 (6-8-93)	Final Rule to Implement Law Requiring Annual Audits, New Reporting Requirements (Part 363)
FIL-43-93 (6-8-93)	Final Rule on Annual Audits and New Reporting Requirements (Part 363) New Reporting
RD# 93-155	Implementation of Part 363 and Appendix A -- Guidelines and Interpretations

Contact

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Questions and Answers

Q. Are all insured depository institutions subject to the requirements of section 36?

A. No. Institutions with assets of less than $500 million in assets are

exempt.

Q. Section 36 requirements are effective for fiscal years beginning after December 31, 1992. Can the FDIC postpone the effective date until fiscal 1994 to give bankers, directors, and examiners more time to comply with the requirements?

A. No. Postponing the effective date would require a legislative change.

Q. Section 36 permits institutions that are subsidiaries of holding companies to satisfy the audit requirements by submitting audited consolidated financial statements of the holding company. Will institutions be required to submit any "institution only" information?

A. No. However, since the filing of consolidated financial statements of the holding company is permissive, institutions may choose to file "institution only" financial statements at their option or they may file consolidated financial statements and institution specific management letters.

Q. Each institution covered by section 36 is required to have an audit committee comprised entirely of outside directors. If a institution is closely held and has no outside directors, can it receive an exemption from this provision?

A. No. Audit committees must be comprised entirely of outside directors. The FDIC does not have authority to waive this requirement.

Q. If the institution is a subsidiary of a holding company, must it have its own audit committee in addition to the holding company's audit committee?

A. If the institution has assets of less than $5 billion, or between $5 billion and $9 billion with a composite CAMEL rating of 1 or 2, it may rely on

the holding company audit committee and need not have its own separate audit committee so long as the members of that committee meet the requirements applicable to the largest subsidiary institution. Other institutions, including all those with assets over $9 billion, and those between $5 billion and $9 billion with a composite CAMEL rating of 3, 4, or 5, have to have separate audit committees whose members are independent outside directors of the specific institution. Subsidiary institution audit committee members may also be outside directors, but not officers or employees, of the holding company.

Q. Section 36 requires the audit committee of a "large" institution to have access to its own outside counsel. Does this require a large institution's audit committee to have legal counsel on retainer?

A. No. All that is required is that the audit committee have the ability to hire outside counsel if it sees the need to do so. Some institutions may have a charter for the audit committee that includes the right for the committee to hire legal or other counsel or other institutions may have the right through a board resolution or in the institution's by-laws. An audit committee is expected to have a budget which permits access to this counsel.

APPLICATION PROCEDURES

Policy

Purpose

Section 115 of FDICIA amends section 5 of the Federal Deposit Insurance Act to provide that any depository institution seeking federal deposit insurance must apply to the FDIC. These provisions give the agency responsible for the deposit insurance funds the authority to set entrance requirements for all insured institutions.

Summary

The amendments to section 5 were effective on December 19, 1991. In general, the revisions provide that any depository institution which is engaged in the business of receiving deposits other than trust funds, upon application to and examination by the Corporation and approval by the Board of Directors, may become an insured depository institution. Two exceptions to the general rule are:

(1) Any interim Federal depository institution that is chartered but will not open for business, becomes an insured depository institution upon the issuance of the institution's charter; and

(2) Application and approval is not required in cases of continued deposit insurance pursuant to section 4 of the Federal Deposit Insurance Act.

The FDIC must consider the factors listed in section 6 of the Federal Deposit Insurance Act in determining whether to approve any application for insurance. If the FDIC denies an application for insurance, it must notify the appropriate

Federal banking agency and/or the State banking supervisor, giving specific reasons for the decision. The Board of Directors may not delegate its authority to deny any deposit insurance application.

Effect on Supervision Activities

The Board of Directors adopted a revised Statement of Policy Regarding Applications for Deposit Insurance effective April 13, 1992. This policy statement reflects standards for all depository institutions seeking Federal deposit insurance.

Sources

RD#92-083 (7-15-92)	Deposit Insurance Policy Statement
RD# 92-099 (8-12-92)	Processing of Deposit Insurance Applications from Proposed National and State Member Banks

Contact

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ACCOUNTING REQUIREMENTS

Statutory Provision

Purpose

Section 121 of FDICIA adds section 37 to the FDI Act and sets objectives and standards for the accounting principles applicable to the preparation of financial reports that insured depository institutions file with the federal banking agencies and promotes the uniformity of regulatory accounting principles among the agencies. The reports covered by section 121 include Reports of Condition and Income (Call Reports) and the annual reports that must be submitted by institutions subject to the audit and reporting requirements of Part 363. (Part 363 implements section 112 of FDICIA.)

Summary

Regulatory Accounting Principles. The objectives of regulatory accounting principles are to accurately reflect capital and to facilitate effective supervision and prompt corrective action. These principles should be uniform among the federal banking agencies and should be consistent with generally accepted accounting principles (GAAP). However, if a particular generally accepted accounting principle is inconsistent with the stated objectives, the agencies may prescribe a regulatory accounting principle that differs from, but is no less stringent than, GAAP. Any regulatory accounting principle or reporting requirement that fails to comply with the stated objectives or that is less stringent than GAAP must be modified or eliminated by December 19, 1992. In addition, all assets, liabilities, and off-balance sheet items are required to be reported in the financial reports filed with the federal banking agencies.

Market Value Disclosure. The banking agencies must develop a method for insured depository institutions to provide supplemental disclosure of the estimated fair market value of assets, liabilities, and off-balance sheet items, to the extent feasible and practicable, in financial reports filed with the federal banking agencies.

Reports to Congress. Each banking agency must annually submit to the House and Senate Banking Committees a report describing any differences in the accounting and capital standards among the federal banking agencies. The report must also be published in the Federal Register.

Status

Based on its review of the regulatory accounting principles and reporting requirements applicable to financial reports filed with the FDIC, DOS believes that, when taken as a whole, these accounting principles and requirements comply with the objectives and standards set forth in section 121 of FDICIA. The FDIC's annual report on accounting and capital differences was submitted to the House and Senate Banking Committees on December 23, 1992, and published in the Federal Register on January 19, 1993. To ensure that banks report all assets, liabilities, and off-balance sheet items in their Call Reports, Report of Condition Schedule RC-L was revised as of March 31, 1993, to include an item for "all other off-balance sheet assets" to complement an existing item for "all other off-balance sheet liabilities."

To assist in implementing the market value disclosure provision of section 121, the Federal Financial Institutions Examination Council (FFIEC) published a request for comment on certain issues pertaining to the disclosure of this information. For the Part 363 annual reports, the agencies proposed that, to be

consistent with GAAP, disclosures about the fair values of those assets, liabilities, and off-balance sheet items that are financial instruments should be made in accordance with Financial Accounting Standards Board Statement No. 107 (FASB 107). The agencies also requested comment on the feasibility and practicability of requiring supplemental unaudited disclosures about the fair values of nonfinancial assets and liabilities in the Part 363 annual reports. In addition, the agencies solicited public comment on whether it is feasible and practicable for insured depository institutions to include annual supplemental fair value disclosures for their assets, liabilities, and off-balance sheet items in their Call Reports and Thrift Financial Reports.

Sources

FIL-97-92 (12-31-92)	Revisions to the Reports of Condition and Income
FIL-33-93 (5-3-93)	Request for Comment on Disclosure of Estimated "Fair Values"

Contact

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LOAN INFORMATION

Reporting Requirements

Purpose

Section 122 of FDICIA directs the federal banking agencies to collect information from insured depository institutions for use in assessing the availability of credit to small businesses and small farms.

Summary

Section 122 requires that the federal banking agencies adopt regulations requiring insured depository institutions to annually submit as part of their "reports of condition" information on small business and small farm lending that the agencies need to assess the availability of credit to these sectors of the economy. The statute does not mandate the specific information that the agencies should require institutions to submit, but does suggest types of information that could be collected.

Status

The Federal Financial Institutions Examination Council (FFIEC) approved annual reporting requirements for insured depository institutions on loans to small businesses and small farms (see Federal Register November 17, 1992). Beginning June 30, 1993, and annually thereafter, the required information is to be collected in the bank Reports of Condition and Income (Call Report), the Thrift Financial Report, and the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks. Insured institutions must report information on the number and

amount currently outstanding of commercial and agricultural real estate loans, and commercial and agriculture loans by certain original size groupings. Business loans with original amounts of $1 million or less and farm loans with original amounts of $500,000 or less serve as proxies for loans to small businesses and small farms. Although the statute suggests information on income and charge-off data could be collected, these are not included in the final annual reporting requirements.

The FDIC Board of Directors has adopted amendments to Part 304 to, among other things, indicate that insured institutions under the FDIC's supervision must report information on small business and small farm loans to the FDIC in the Call Report. These amendments were effective July 6, 1992, although the collection of information on small business and farm loans would begin only when the FFIEC adopted final reporting requirements.

Sources

FIL-97-92 (12-31-92)	Revisions to the Reports of Condition and Income
Other	March 31, 1993 Call Report Instructions for Schedule RC-C, Part II

Contact

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PROMPT CORRECTIVE ACTION

Final Rule

Purpose

Section 131 of FDICIA amends the FDI Act by adding a new section 38 entitled, "Prompt Corrective Action" ("PCA"). Section 38 requires or permits the FDIC to take certain increasingly severe supervisory actions as an institution falls within one of five capital categories. The PCA provisions do not in any way limit the FDIC's ability to take other supervisory actions, including section 8 actions against banks, however, the overall purpose of section 38 is to resolve the problems of insured depository institutions at the least possible long-term loss to the deposit insurance fund. Thus, the FDIC and the other Federal regulators have the authority to take prompt corrective actions against insured banks, including insured branches of foreign banks.

Summary

Subpart B of Part 325 of the FDIC's regulations define the capital measures and capital levels (and for insured foreign branches, the capital equivalents) used for determining which institutions are subject to the supervisory actions authorized or required under section 38. The regulation also establishes procedures for submission and review of capital restoration plans and for issuance and review of PCA directives. Hearing procedures for reclassification of banks and review of dismissals of officers and directors are provided under section 308.2 of the FDIC's regulations.

Five capital categories are established and defined.

Well capitalized:

- Total risk-based capital ratio of at least 10.0 percent; and
- Tier 1 risk-based capital ratio of at least 6.0 percent; and
- Leverage capital ratio of at least 5.0 percent; and
- Not subject to any written agreement, order or directive to meet and maintain a specific capital level.

Adequately capitalized:

- Total risk-based capital ratio of at least 8.0 percent; and
- Tier 1 risk-based capital ratio of at least 4.0 percent; and
- Leverage ratio of at least 4.0 percent (3.0 percent for 1-rated institutions not experiencing or anticipating significant growth).

Undercapitalized:

- Fails to meet one or more of the required minimum capital levels needed to be classified as "adequately capitalized".
- Must file a capital restoration plan within 45 days of the date it becomes undercapitalized; and
- Subject to automatic restrictions on dividend and management fees, asset growth restrictions, and prohibitions against making acquisitions, opening branches or engaging in new lines of business without the prior approval of its primary federal regulator; and
- Other harsher restrictions may be imposed on a case-by-case basis.

Significantly undercapitalized:

- Total risk-based capital ratio of less than 6.0 percent; or
- Tier 1 risk-based capital ratio of less than 3.0 percent; or
- Leverage ratio of less than 3.0 percent.
- Subject to the restrictions that automatically apply to undercapitalized institutions, plus other limitations, including mandatory prohibitions

against the payment of bonuses and raises to senior officers without the regulator's prior approval.

<u>Critically undercapitalized:</u>

- "Tangible equity" to total assets ratio of 2.0 percent or less. (Tangible equity is a newly defined term, used for this purpose only which combines elements of core capital and cumulative perpetual preferred stock minus all intangible assets except for limited amounts of purchased mortgage servicing rights.)
- Subject to the restrictions that apply to undercapitalized and significantly undercapitalized institutions, plus other prohibitions which may be imposed by FDIC regardless of charter deposits.

At a minimum, <u>any</u> critically undercapitalized institution, regardless of its primary federal regulator, is prohibited from any of the following without the FDIC's prior approval:

- Entering into any material transaction other than the usual course of business.
- Extending credit for any highly leveraged transaction.
- Amending its charter or bylaws except to the extent necessary to carry out any other requirement of any law or order.
- Making any material change in its accounting methods.
- Engaging in any "covered transaction" within the meaning of section 23A(b) of the Federal Reserve Act (concerning affiliate transactions).
- Paying excessive compensation or bonuses.
- Paying interest on new or renewed liabilities at a rate which would increase the institution's weighted average cost of funds to a level significantly exceeding the prevailing rates in the institution's normal market areas. (See also section 337 of the FDIC's regulations, titled

"brokered deposits.")

- Paying principal or interest on the institution's subordinated debt beginning 60 days after becoming critically undercapitalized.

The application requirements for FDIC approvals are contained in section 303.5 of the FDIC's regulations.

Institutions that fall below the 2.0 percent tangible-equity-capital-to-total-assets level must be placed in conservatorship or receivership within 90 days of becoming critically undercapitalized, unless there is an extension granted.

The agency discretionary restrictions are imposed by means of a PCA directive.

Effect on FDIC Operations

Prompt corrective action does not replace existing regulatory tools to improve capital adequacy. The PCA capital category designations and related restrictions are more of a supervisory framework which supplements existing supervisory authorities under section 8 of the FDI Act. For example, an institution that meets the PCA capital requirements for a "well capitalized" bank may still be required to hold additional capital for safety and soundness reasons. PCA should <u>not</u> be considered a determination of overall capital adequacy.

Status

The FDIC, in parallel with the other three federal banking agencies, adopted final rules effective December 19, 1992, for implementing prompt corrective action. Certain technical amendments to the regulations affecting delegations of authority and application procedures became effective in early 1993. Currently, the delegations of authority to the regional level on this subject involve the approval

or denial of capital restoration plans and related holding company guarantees. All other decisions involving PCA directives and other actions related to banks in the three lowest capital categories must be acted on by the Washington Office.

Sources

FIL-50-92 (7-10-92)	Proposal to Implement "Prompt Corrective Action" Requirements
PR-128-92 (9-15-92)	FDIC Adopts Final "Prompt Corrective Action" Rule
FIL-70-92 (10-5-92)	Final Rule Implementing "Prompt Corrective Action" Requirements (Parts 308 and 325)
RD# 92-138 (11-5-92)	Advance Notification under Prompt Corrective Action ("PCA")
RD# 92-139 (11-9-92)	Conservatorship and Receivership Amendments To Facilitate Prompt Regulatory Action
RD# 92-153 (12-14-92)	Advance Notification Under Prompt Corrective Action
RD# 93-24 (2-9-93)	Dismissal of Directors and Senior Executive Officers Under Prompt Corrective Action
FIL-12-93 (2-22-93)	Applications for Approval to Conduct Restricted Activities, Technical Amendments on Capital Maintenance Standards (Parts 303 and 325)
RD# 93-43 (3-16-93)	Prompt Corrective Action Procedures and Delegations of Authority
RD# 93-127 (8-24-93)	Bank Holding Company Guarantees Under Prompt Corrective Action

Contacts

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Questions and Answers

PCA Restrictions Applicable To All Banks

Q. Are all insured depository institutions, regardless of their capital category, subject to some PCA restrictions?

A. Yes, any insured depository institution is prohibited from:

- Declaring any dividend or making any other capital distribution if, after making such distribution, the institution would be undercapitalized;
- Paying a management fee to a controlling person if payment would result in the institution being undercapitalized; or,
- Declaring any stock redemption unless it does not result in a decrease in capital, improves the institution's financial condition and is approved by the FDIC.

Restrictions On Undercapitalized Banks

Q. What restrictions apply to undercapitalized banks?

A. Undercapitalized banks are subject to both automatic and discretionary restrictions under PCA. The automatic restrictions apply when an institution becomes undercapitalized and apply without any action by the FDIC. The mandatory restrictions for state nonmember banks are:

- Submission to the FDIC, within 45 days of becoming undercapitalized, a capital restoration plan. If applicable, the plan must include a holding company guaranty in order for it to be approved.
- Limits on growth in average total assets.
- Prior approval by the FDIC for the bank to make any acquisition, open any new offices, or engage in any new line of business. (The applicable application procedures are contained in section 303.5 of the FDIC's regulations.)
- A prohibition against declaring any dividend or making any other capital distribution.
- A prohibition against paying a management fee to a controlling person.
- Non-PCA restrictions include a prohibition on accepting brokered deposits (section 337.6 of the FDIC's regulation) and limitations on Federal Reserve discount window privileges (section 10(a) and (b) of the Federal Reserve Act).

Undercapitalized banks are also subject to certain discretionary restrictions if the FDIC determines that those actions are necessary. Discretionary restrictions are imposed through PCA directives.

Q. What if an undercapitalized bank fails to submit or implement an acceptable capital restoration plan?

A. The bank will be treated as if it were significantly undercapitalized for PCA purposes.

Restrictions on Significantly Undercapitalized Banks

Q. Are significantly undercapitalized banks subject to the mandatory

restrictions applicable to undercapitalized banks?

A. Yes, state nonmember significantly undercapitalized banks are subject to all of the mandatory restrictions applicable to undercapitalized institutions. In addition, they must receive the prior approval from the FDIC to increase pay or to pay bonuses to senior executive officers of the institution. Further, the FDIC must take one or more of the following actions, unless it determines that the actions would not further the purposes of section 38:

- Require the institution to sell enough shares or obligations so that it will be adequately capitalized after the sale; or, require the institution to be acquired by a depository institution holding company, or to combine with another insured depository institution, if one or more grounds exist for the appointment of a conservator or receiver of the institution;
- Require the institution to comply with section 23A of the Federal Reserve Act as if subsection section exempting transactions with certain affiliated institutions did not apply; and,
- Restrict the interest rates paid on deposits.

These banks also will be subject to <u>one or more</u> discretionary restrictions that the FDIC may impose, including the following:

- Restrict the institution's asset growth more stringently than for undercapitalized banks or require a reduction.
- Require the institution or any subsidiary to terminate, reduce or alter any activity posing excessive risk.
- Require the institution to improve management.
- Prohibit the institution from accepting correspondent bank deposits;
- Prohibit the holding company from making any capital distribution without the prior approval of the appropriate federal agency.

- Require the institution or its holding to take one or more of actions to divest the institution, subsidiaries or affiliates.
- Require the institution to take any other action that would better carry out the purposes of section 38.

In addition, the holding company may be prohibited from paying any dividends without the prior approval of the appropriate agency.

Restrictions on Critically Undercapitalized Banks

Q. Are there any other restrictions on critically undercapitalized institutions?

A. Yes, the FDIC may restrict the activities of <u>any</u> critically undercapitalized bank to carry out the purposes of section 38 of the FDIC Act. Section 325.105(a)(4) of the FDIC's regulations lists the additional restrictions applicable to critically undercapitalized institutions.

Q. When must a critically undercapitalized institution be closed?

A. The primary federal regulator must appoint a receiver or, with the concurrence of the FDIC, a conservator within 90 days of the institution becoming critically undercapitalized unless the primary federal regulator with the concurrence of the FDIC determines that some other action would better achieve the purpose of section 38 of the FDI Act. A redetermination must be made at least every 90 days. If the institution is still critically undercapitalized on average during the calendar quarter 270 days after it became critically undercapitalized, the primary federal regulator must appoint a receiver unless it determines, and the FDIC concurs, that the institution:

- has a positive net worth;
- has been in substantial compliance with an approved capital restoration plan,

- is profitable or has an upward trend in earnings, and
- is reducing its ratio of nonperforming loans to total assets.

The head of the appropriate federal banking agency and the Chairperson of the FDIC both must certify that the institution is viable and not expected to fail.

See also Section 133 of FDICIA which contains 12 grounds for appointing a conservator or a receiver, including that an institution is critically undercapitalized. That section also provides that the FDIC Board of Directors may appoint itself as conservator or receiver.

Capital Levels and Capital Categories

Q. Do the PCA capital requirements replace the FDIC's existing capital adequacy requirements?

A. No, the pre-existing capital requirements in Subpart A of Part 325 are separate and apart from the PCA provisions established in subpart B of Part 325. A bank that meets the requirements for a well capitalized bank under PCA may still be required to hold additional capital due to other safety and soundness concerns.

Q. Does a bank have to calculate its capital position on a daily basis to determine its capital category?

A. In most cases, no. Unless there is a material event that would reduce the bank's capital, it is generally sufficient for a bank to calculate its capital position quarterly when preparing its Call Report. However, banks that operate with capital near the regulatory minimums should calculate their capital ratios frequently enough to ensure that they do not trigger PCA restrictions applicable to undercapitalized institutions.

Q. How does the tangible equity capital ratio defining critically undercapitalized banks differ from the Tier 1 ratio defining the other categories?

A. The tangible equity capital ratio includes all the core capital elements recognized in Tier 1 capital. It also includes any cumulative perpetual preferred stock and related surplus carried as part of Tier 2. From this amount, all intangible assets must be deducted (except for purchased mortgage servicing rights, which may be counted to the extent they count as Tier 1 capital). Thus, certain intangibles that count for Tier 1 capital purposes, such as purchased credit card relationships, are deducted in calculating tangible equity.

Banks Subject to Orders or Agreements to Raise Capital

Q. If a bank is under an order that covers only consumer compliance, is the bank considered not well capitalized for PCA purpose?

A. No, the definition of a well capitalized bank states that only enforceable agreements, orders, directives that specifically require a bank to meet and maintain a specific level of capital will preclude a bank from being in the well capitalized category.

Q. Is a bank that is subject to an order, agreement, or directive to meet and maintain a specific capital level considered well capitalized if it is in compliance with the order, agreement or directive?

A. No, a bank subject to such an order, an agreement, or directive will not be deemed to be well capitalized, regardless of whether or not it is in compliance. The order must be formally rescinded or amended by the FDIC to eliminate the requirement to meet or maintain a specific capital level before the institution can be deemed to be well capitalized.

Q. Can a bank subject to a memorandum of understanding, a commitment letter or a board resolution that calls for the institution to meet or maintain a specific capital level be considered well capitalized?

A. Yes, these informal actions do not affect a bank's PCA category. Only those orders, agreements, or directives specifically cited in the well capitalized definition prohibit a bank from being considered well capitalized.

Restrictions on Disclosure of Capital Category

Q. Can a bank advertise its capital category?

A. A bank or an insured branch of a foreign bank may not utilize its capital category for advertising or promotional purposes, unless such disclosure is required by law or is authorized by the FDIC. However, the FDIC recognizes that disclosure of a bank's capital category may be appropriate in certain circumstances and under certain conditions. For example, disclosure of an institution's PCA capital category and the related regulatory restrictions may be required under federal securities and banking laws in an institution's securities filings or in annual or quarterly reports.

Q. Can a bank disclose, upon request, its PCA capital category to an investor, a customer or other third party?

A. Yes. The restrictions on disclosure for advertising or promotional purposes do not prohibit a bank from disclosing its PCA capital category in response to inquiries from investors, customers, or other third parties. However, such disclosures should include appropriate caveats in order to avoid misleading the public. For example, any bank that discloses its PCA capital category to the public should also disclose that the bank's capital category is determined solely for the purposes of applying the PCA

provisions and that the institution's PCA capital category may not constitute an accurate representation of the bank's overall capital adequacy, financial condition or future prospects.

Notice of Capital Category

Q. Will a state nonmember bank or insured foreign branch receive notice from the FDIC that it is considered to be undercapitalized for PCA purposes?

A. The bank is generally deemed to have received notice of its capital category when it files its Call Report. For most institutions this is 30 days from the quarterly Call Report date. The bank also is deemed to be on notice of its capital category if the FDIC determines, as a result of an examination or other information, that the bank should be in a different capital category from that indicated in its Call Report and so notifies the bank in writing.

Q. If a material event occurs that would place the state nonmember bank in a lower capital category, how quickly must the bank notify the FDIC?

A. The bank must provide a written notice to the appropriate FDIC DOS regional director within 15 calendar days of the occurrence of any material event. After receiving notice, the FDIC will determine whether to change the capital category and will notify the bank of its determination.

Q. Is the bank required to notify the FDIC when a material event occurs that would place the bank in a higher capital category?

A. No. However, the bank may ask the appropriate FDIC regional director to reconsider its capital category.

Reclassification

Q. How can a bank be moved to a lower capital category based on factors other than the bank's capital level?

A. The FDIC can reclassify a well capitalized state nonmember bank as adequately capitalized and can order an adequately capitalized or undercapitalized bank to comply with certain restrictions applicable to institutions in the next lower capital category, if the FDIC determines, after notice and opportunity for hearing, that the bank is in an unsafe or unsound condition or is engaged in an unsafe or unsound banking practice, including having a less than satisfactory rating for assets, management, earnings, or liquidity during its most recent examination. This is taken to mean a rating of 3, 4, or 5 or on the AMEL components of CAMEL.

Q. What is the definition of "unsafe or unsound condition or practice?"

A. Neither the statute nor the regulation define "unsafe or unsound condition or practice." However, section 8(b)(8) of the FDI Act as amended by FDICIA, provides that if the insured depository institution receives a less-than-satisfactory rating for asset quality, management, earnings, or liquidity, the agency may (if the deficiency is not corrected) deem the institution to be engaging in an unsafe or unsound practice.

PCA Directive: Procedures and Enforcement

Q. Is a bank entitled to any hearing or review prior to the implementation of discretionary restrictions under PCA?

A. The FDIC generally will provide a notice of intent to issue a PCA directive when applying a discretionary restriction under PCA. The bank generally will have at least 14 days to respond to the notice. As an alternative, the FDIC can make the PCA directive effective immediately,

in which case, the institution may appeal. After the FDIC reviews the bank's written response, it may issue the directive as proposed, modify it, determine not to issue it or seek additional information.

Q. Who within the FDIC will be making the determination to impose discretionary restrictions on a bank?

A. In most cases the initial recommendation will be made in an examination report by a field examiner. The determination will be made by the appropriate regional director, senior Washington Office person, or FDIC Board, consistent with the delegations that may exist. In all cases the initial recommendation will receive, at a minimum, a second level review prior to issuance of a notice and PCA directive.

Q. Is a PCA directive enforceable?

A. Yes, a PCA directive is enforceable under 12 U.S.C. 1818 to the same extent as a final cease and desist order.

Capital Restoration Plans and Holding Company Guarantees

Q. What is the deadline for submitting a capital restoration plan?

A. A bank shall submit a written capital restoration plan to the appropriate regional director within 45 days of having notice that it is undercapitalized or worse.

Q. If an undercapitalized bank is already operating under a capital plan that is approved by the FDIC pursuant to either a formal or an informal enforcement action is it exempt from the requirement to submit a capital restoration plan?

A. No, a capital plan submitted pursuant to other enforcement action will not qualify as a PCA capital restoration plan. The bank must update the plan

to address the criteria in the law and regulations. For example, the capital plan may require updating to provide a guarantee by the bank's holding company.

Q. What kind of performance guarantee is required of a holding company of a bank submitting a capital restoration plan?

A. The bank holding company must provide a written guarantee of the capital restoration plan. The guarantee should, at a minimum, include a commitment to take actions required by the capital restoration plan, including, for example, assuring that competent management will be selected, restricting transactions between the bank and the holding company, discontinuing certain risky activities within the bank or an affiliate and assuring that the bank will fulfill the commitments to raise capital made in the capital plan. The adequacy of such guarantees and assurances of performance will be determined on a case-by-case basis. Also, the holding company guarantee should indicate that it will remain in effect until the bank has been adequately capitalized on average for four consecutive calendar quarters.

Dismissal of Officers and Directors

Q. What rights of review, if any, does a dismissed director or senior executive officer have under PCA?

A. Section 308 of the FDIC's regulations describes the procedures available to dismissed individuals for requesting reinstatement. An individual generally has 10 days from the date of service of the PCA directive of dismissal to file a request for reinstatement. Dismissed persons may request an informal hearing. In order to be reinstated, the dismissed individual must show that his or her employment would materially strengthen the bank's ability to become adequately capitalized or correct

the unsafe or unsound banking condition or practice.

Q. Can the dismissed individual continue to serve in the bank while the petition for reinstatement is pending before the FDIC?

A. No, the individual is dismissed from the institution when the FDIC issues a final PCA directive of dismissal on the bank. A copy of the PCA directive will be provided simultaneously to the affected individual.

Q. Who in the FDIC will be making the determination to dismiss a director or senior executive officer under PCA?

A. A final PCA directive of dismissal will be issued in the Washington Office, generally after receiving the institution's response and the regional director's recommendation on the response.

Q. Is the dismissed individual prohibited from working in any FDIC-insured institution or in an affiliate?

A. No, the dismissed individual is only prohibited from serving at the institution subject to the PCA directive. The prohibition does not appear to apply to other depository institutions or to the parent company and the affiliates. Bank subsidiaries may be affected under certain circumstances. The statute specifically states that a dismissal under PCA shall not be construed as a removal under section 8 of the FDI Act. If it is deemed appropriate to prohibit the individual from working in any other FDIC-insured institutions or affiliates, a separate section 8(e) removal action should be pursued.

PCA Exemptions

Q. Do any of the PCA provisions apply to government-owned institutions like conservatorships or bridge banks?

A. Other than the section dealing with asset growth restrictions, the FDI Act specifically exempts insured depository institutions for which the FDIC or the RTC is conservator or sole owner(s) of a bridge bank.

Q. Are there any other exemptions for insured depository institutions under PCA?

A. Yes, section 38 states, in part, that a savings association that is complying with a capital restoration plan approved by the OTS before December 19, 1991, the effective date of FDICIA, is not required to file another capital plan, and is not automatically subject to the section 38 restrictions applicable to significantly and critically undercapitalized institutions. This exemption from the section 38 restrictions remains in effect until July 1, 1994.

SAFETY AND SOUNDNESS STANDARDS

Proposed Rule

Purpose

Section 132 of FDICIA adds a new section 39 to the FDI Act that requires each Federal banking agency to prescribe by regulation safety and soundness standards. In enacting section 39, Congress sought to protect the deposit insurance funds by having the agencies identify and address problems at institutions or holding companies before capital becomes impaired.

Summary

The new section 39 applies to three principal areas: (1) operations and management, (2) asset quality and earnings, and (3) compensation. An insured depository institution or holding company that fails to meet any of the prescribed standards, except the standard prohibiting the payment of excessive compensation and compensation that could lead to a material financial loss, will be required to submit and implement an acceptable plan to achieve compliance. Failure to submit or implement such a plan within the time allowed by the agency will result in an order to correct the deficiency. The agency may take other supervisory actions until the deficiency has been corrected.

Section 39(a) requires the agencies to prescribe by regulation operational and managerial standards relating to:

- internal controls, information systems, and internal audit systems
- loan documentation
- credit underwriting
- interest rate exposure

- asset growth
- compensation, fees, and benefits

Section 39 (b) requires the agencies to prescribe by regulation standards specifying:

- a maximum ratio of classified assets to capital
- minimum earnings sufficient to absorb losses without impairing capital
- to the extent feasible, a minimum ratio of market value to book value for publicly traded shares of institutions and holding companies.

Section 39(c) requires the agencies to prescribe by regulation standards prohibiting as an unsafe and unsound practice excessive compensation or compensation that could result in a material financial loss to an institution. Unlike the other standards, a violation of this standard cannot be remedied via a compliance plan but must be remedied by a proceeding brought pursuant section 8(b) of the FDI Act.

The proposed regulation, Part 364 -- Standards for Safety and Soundness establishes objectives of proper operations and management while leaving the specific methods for achieving those objectives to each institution. The proposed regulations formalize the fundamental standards already used by the agencies to assess institutions. Well-managed institutions should not find it necessary to change their operations to comply with this proposal. Moreover, the proposal indicates smaller institutions may require less sophisticated systems and practices.

Status

On November 18, 1993 the agencies published in the Federal Register for a 45-day comment period a proposal with a common preamble and parallel regulatory

text (see 58 FR 60802). Final regulations are supposed to be in effect by December 1, 1993.

Sources

FIL-55-92 (7-22-92)	View Being Solicited on New Standards for Safe and Sound Operations at Banks and Thrifts
PR-65-93 (6-9-93)	FDIC Proposes Rule on Safety and Soundness Standards

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CONSERVATORSHIPS AND RECEIVERSHIPS

Statutory Provision

Purpose

Section 133 of FDICIA amends section 11(c) of the FDI Act. It became effective on December 19, 1992. These amendments expand the grounds of the primary federal regulator for appointing a conservator or receiver and grant new authority to the FDIC Board of Directors to appoint the FDIC as conservator or receiver in certain situations. These new provisions also encourage early resolution of troubled banks.

Summary

Section 11(c)(5) of the FDI Act lists 12 grounds for appointing a conservator or receiver (which may be the FDIC) for an insured institution:

- (A) assets insufficient for obligations,
- (B) substantial dissipation,
- (C) unsafe and unsound condition,
- (D) cease and desist orders,
- (E) concealment,
- (F) inability to meet obligations,
- (G) losses,
- (H) violations of law,
- (I) consent,
- (J) cessation of insured status,
- (K) under capitalization, and
- (L) critically undercapitalized or has substantially insufficient capital.

An additional ground covering institutions convicted of money laundering activities was added by the Housing and Community Development Act of 1992, effective December 20, 1992.

The Office of the Comptroller of the Currency and the Office of Thrift Supervision may appoint the FDIC receiver or may appoint a conservator (which may be the FDIC) for any insured depository institution for which they are the primary federal regulator if one or more of the grounds specified in section 11(c)(5) exists. The appropriate federal banking agency shall not appoint a conservator under subparagraphs (K) and (L) without the FDIC's consent unless the agency has given the FDIC 48 hours notice.

Section 11(c)(9) of the FDI Act authorizes the appropriate federal banking agency to appoint a conservator or receiver for an insured state depository institution under their respective jurisdictions if the grounds specified in subparagraphs (K) or (L) of section 11(c)(5) exist and the appointment is necessary to carry out the purpose of the prompt corrective action provisions under section 38 of the FDI Act. The state supervisor must be consulted prior to the appointment.

Section 11(c)(10) of the FDI Act authorizes the FDIC Board of Directors to appoint the FDIC as sole conservator or receiver of an insured depository institution, after consultation with the appropriate federal banking agency and the appropriate state supervisor (if any), if the FDIC Board of Directors determines that one or more grounds exist under section 11(c)(5) and the appointment is necessary to reduce the risk of loss that would occur or is expected to occur with respect to the deposit insurance fund.

Effect on FDIC Operations

A troubled institution conceivably could meet one or more of the expanded

grounds for appointing a conservator or receiver contained in section 11(c)(5), even though its tangible equity capital is greater than the two percent "critically undercapitalized" threshold under PCA. It is expected that the FDIC and the other federal regulators will exercise their new authority when warranted. Because premature closure of an otherwise viable institution would not be in the best interest of the deposit insurance fund, the determination of when to recommend appointment of a receiver will be made on a case-by-case basis.

The Division of Supervision is responsible for identifying those insured depository institutions which may meet one or more grounds for appointment, and, coordinating action with other FDIC Divisions and the federal or state regulators. If appropriate, DOS will join in recommending to the FDIC Board of Directors receivership (or in certain unique cases, a conservatorship) of nonviable insured depository institutions.

Status

On December 17, 1992, the Legal division distributed model legal documents and other guidance on the "self appointment" provisions in FDICIA sections 131 and 133.

Source

RD# 92-139 (11-9-92)	Conservatorship and Receivership Amendments To Facilitate Prompt Regulatory Action

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Questions and Answers

Q. When does the FDIC anticipate using its self appointment powers?

A. The most likely scenario is when a state chartering authority is unable to close a state nonmember bank on a timely basis after it is determined that appointing a receiver is appropriate. This may occur because most states' laws still define insolvency as when liabilities exceed assets or when equity or total capital is exhausted. The FDIC will closely coordinate with state banking departments on this issue. The FDIC prefers that the chartering authority continue to be the one to close institutions, when it is deemed appropriate.

Q. How does the "two percent rule" under prompt corrective action relate to the grounds in section 11(c)(5) of the FDI Act?

A. The "two percent critically undercapitalized rule" under PCA is one of the 12 grounds listed in section 11(c)(5) of the FDI Act. Under section 38(h) of the FDI Act, the primary federal regulator must appoint a receiver or, with the concurrence of the FDIC, a conservator within 90 days of the institution becoming critically undercapitalized unless the primary federal regulator, with the concurrence of the FDIC, determines that other action would better achieve the purpose of section 38 of the FDI Act. In most cases, one or more of the other Section 11(c)(5) grounds will also have been met by the time an institution becomes critically undercapitalized.

Q. If an institution typically will meet one or more grounds before becoming critically undercapitalized, how does one determine when to recommend closing an institution?

A. Determining when to recommend closing an institution will be based on a careful assessment of the overall condition of the institution and its

future prospects, including the likelihood that the institution will be recapitalized and can meet all currently applicable capital standards without federal assistance. Whether to recommend use of the power will involve a great deal of judgement on the part of the examiner and the regional office. The primary regulator and the FDIC will have to weigh the estimated costs to the insurance fund of resolving or liquidating an institution, the potential cost savings of keeping an institution open that appears to be viable or has prospects for a no cost or minimal cost solution, and the risks that an institution which appears to be viable at the time may deteriorate even further. As a practical matter, this assessment should be performed for all 4- and 5-rated institutions.

Q. When will DOS recommend that a resolution or some other assistance transaction be considered?

A. When the Washington Office concurs in a regional recommendation that an institution meets one or more grounds under section 11(c)(5) of the FDI Act and it is unlikely that the institution will meet all applicable capital standards without federal assistance, a recommendation to DOR will be made. It is important that DOR be kept advised of cases as they become known to the Region.

LEAST-COST RESOLUTION

Statutory Provision

Purpose

Section 141 of FDICIA, among other things, amending sections 11 and 13 of the FDI Act, requires the FDIC to deal with failing institutions in a manner that is least costly to the deposit insurance funds. Section 143 of FDICIA encourages early resolution of troubled banks if that is the least costly to the insurance fund and satisfies other criteria.

Summary

Before FDICIA, the FDIC became formally involved in the resolution of a failing insured depository institution when requested by the chartering authority to act as receiver. Any transaction that was arranged had to meet a statutory cost test of being less expensive to the deposit insurance fund than a payoff of the institution's depositors. When a bank was declared insolvent, the FDIC first attempted to arrange an assumption of all of the bank's deposits by another institution, including deposits above $100,000. In rare instances, the FDIC assisted the acquisition of all deposits even if it was not possible to determine whether the result would be less costly than a payoff up to the insurance limit under a pre-FDICIA provision of the FDI Act which permitted the FDIC to provide assistance if a bank was "essential to provide adequate depository services in its community".

Section 141 of FDICIA changed the statutory cost test by requiring the FDIC to use the least costly of all possible methods to satisfy its insurance obligations and replaced the "essentiality test" with a "systemic risk" test. A "systemic risk"

finding requires consultation between the regulators and the Secretary of the Treasury (in consultation with the President) to certify that this alternative is necessary to prevent serious adverse effects on the economy or to assure financial stability. After December 31, 1994, or at such earlier time as the FDIC determines appropriate, the FDIC may not take any action that would have the effect of increasing losses to any insurance fund by protecting depositors for more than the insured portion or creditors. The FDIC is required to prescribe regulations implementing the new restrictions on deposit insurance payments by January 1, 1994. A proposed rule on the least-cost resolution requirements of section 141 of FDICIA was published in the Federal Register on October 25, 1993 (see 58 FR 55027). The proposed rule generally restates the least-cost resolution requirements of section 141 and the manner in which the FDIC currently complies.

Section 141 amendments also require that the FDIC consider providing direct financial assistance before the appointment of a conservator or receiver under a new "troubled condition" criteria. The "troubled condition" criteria include, in part, that the grounds for the appointment of a conservator or receiver exist or likely will exist in the future unless the institution's capital levels are increased and it is unlikely that the institution can meet all currently applicable capital standards without assistance. There also must be a management competency determination.

Section 143 of FDICIA is a "sense of Congress" provision which encourages the federal banking agencies to facilitate the early resolution of troubled insured depository institutions if early resolution would have the least possible long-term cost to the deposit insurance fund, consistent with the least-cost and prompt corrective action provisions of the FDI Act. This section sets forth principles the agencies should follow in fashioning early resolutions, such as competitive negotiations to sell problem institutions, adequate capitalization, qualified

management and substantial private investment. A "sense of Congress" provision does not have the force of law.

Effect on FDIC Operations

These provisions have significantly reduced the flexibility of the regulators to handle troubled or failing insured depository institutions. For example, in the past, the FDIC was able to use "whole bank" transactions that may have been a less costly but not the least expensive alternative for the deposit insurance fund but which resulted in all depositors being covered, including uninsured, and involved less disruption to the local community. The "least cost" test has resulted in more resolutions where uninsured depositors have incurred a partial loss. On the other hand, section 141 now permits the FDIC to consider "open assistance" proposals when the "troubled condition" criteria are met. Previously, such proposals could be considered only when the institution was "in danger of default." This typically occurred when the chartering authority made a determination of insolvency. This change now permits the FDIC to consider "open assistance" proposals much earlier in the resolution process.

Because "open bank" and "early" resolution proposals typically involve protection of uninsured depositors or other features restricted by FDICIA, their future use is unclear despite the ability of the FDIC to now consider proposals earlier and the encouragement contained in section 143.

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DISCOUNT WINDOW ADVANCES

Statutory Provision

Purpose

Section 142 of FDICIA amends the Federal Reserve Act and limits the ability of Federal Reserve banks to extend discount window advances to troubled institutions. The section reflects a belief that access to the discount window by troubled institutions has allowed banks to remain in operation when they were no longer viable, thereby potentially increasing losses to the deposit insurance fund. The perception was that increased losses occurred as a result of a continuing deterioration of the failing institution's troubled assets and a resultant loss in franchise value and ultimate salability.

Summary

Section 142 of FDICIA generally limits the ability of Federal Reserve banks to advance funds to critically undercapitalized banks (banks with 2 percent or less tangible equity capital) for more than five days after the bank becomes critically undercapitalized. It also generally limits the ability of Federal Reserve banks to advance funds to 5-rated banks or to undercapitalized banks (banks with less than 8 percent total risk-based capital, less than 4 percent Tier 1 risk-based capital, or a Tier 1 leverage ratio below 4 percent) for more than 60 days in any 120-day period.

Advances to 5-rated banks or undercapitalized banks beyond 60 days are permitted if the head of the appropriate federal banking agency certifies that the bank is viable, or if the Federal Reserve Board conducts an examination of the bank and the Chairman of the Federal Reserve Board then makes such

certification. Upon certification, advances may remain outstanding until the end of the 60-day period beginning at the time certification is received. A Federal Reserve Bank may renew the 60-day period upon receiving renewed certification from the certifying agency.

A Federal Reserve bank may not make advances to a 5-rated, undercapitalized, significantly undercapitalized or critically undercapitalized bank without receiving a certificate of viability. However, if a Federal Reserve bank permits such a troubled institution access to the discount window and the bank subsequently fails, the Federal Reserve Board will be liable to the FDIC for any additional losses to the deposit insurance fund. The Fed will also be liable for additional losses incurred by the FDIC if a Federal Reserve bank advanced funds or did not demand the repayment of previously advanced funds after 5 days from the date on which a bank becomes critically undercapitalized. Although this section does not become effective until December 19, 1993, the Fed has committed to immediately implement it.

The Federal Reserve Board issued for public comment on August 31, 1993, proposed amendments to Regulation A (Extensions of Credit by Federal Reserve Banks) to implement section 142 of FDICIA regarding limits on Federal Reserve bank credit (see 58 FR 45851). Comments were requested by October 1, 1993.

Effect on FDIC Operations

Section 142 of FDICIA is likely to limit potential sources of liquidity for troubled institutions. As a result, the liquidity contingency plans of an undercapitalized or 5-rated institution that rely solely on extended advances from the discount window may not be sufficient.

As an institution approaches the critically undercapitalized level, examiners must

evaluate the bank's liquidity based on the assumption that advances from the Federal Reserve bank may not be available 5 days after the date on which it becomes critically undercapitalized.

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Questions and Answers

Q. What is the likely effect of the Fed being liable for additional losses to the FDIC if a Federal Reserve bank allows a troubled institution access to the discount window for more than 60 days without first receiving a certificate that the institution is viable?

A. Although each Federal Reserve bank will make its own lending decisions, Federal Reserve banks will probably be reluctant to advance funds to an undercapitalized or 5-rated institution for more than 60 days in a 120-day period or to any critically undercapitalized.

Q. May the Federal Reserve banks advance funds to critically undercapitalized banks for 5 days without the Federal Reserve Board incurring liability?

A. Yes, but only for the first 5 days from the date on which the bank becomes critically undercapitalized.

Q. What is a "viable" institution?

A. Section 142 (b)(5)(E) says that an institution is "viable" if either the Federal Reserve Board or the institution's primary federal regulator,

giving due regard to the economic conditions and circumstances in the market in which the institution operates, determines that the institution, is not critically undercapitalized, is not expected to become critically undercapitalized, and is not expected to be placed into conservatorship or receivership.

Q. Can the Director, DOS, for example, certify that a bank is viable?

A. No, the certificate must be signed by the Chairman of the FDIC or the Chairman of the Board of Governors of the Federal Reserve System. Section 142 prohibits delegating this authority to any other person.

Q. How will the Federal Reserve Board supervise those institutions that request and are granted advances, particularly those institutions not under the Fed's direct supervision?

A. Section 142 explicitly permits the Federal Reserve to examine any depository institution and its affiliate in connection with any advance or any request for any advance to such a depository institution. It is expected that in the event the Federal Reserve decides to exercise this authority for a state nonmember bank, the examination will be coordinated with the FDIC.

Q. Are the 120-day periods set?

A. There are no pre-set 120-day periods -- it rolls continually.

FOREIGN BANK SUPERVISION

Statutory Provision

Purpose

Sections 201 through 215 of FDICIA constitute the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA). The legislation primarily amends the International Banking Act of 1978 to provide uniform standards for the entry of foreign banks into the United States and to provide for additional and coordinated supervision of such entities' operations.

Summary

FBSEA gives considerable new responsibilities to the Federal Reserve Board (FRB.) Most notably, the law:

- Requires prior approval by the FRB for a foreign bank to establish in the U.S. a branch, agency, commercial lending company, or representative office;
- Establishes mandatory and discretionary standards for entry by foreign banks, including a mandatory requirement that a foreign bank be subject to comprehensive supervision or regulation on a consolidated basis by home country authorities;
- Permits termination of a foreign bank's offices in the United States where there are violations of law or unsafe or unsound practices or where a foreign bank is not subject to consolidated home country supervision;
- Requires that U.S. branches and agencies of foreign banks be examined at least once in every twelve month period, permits the FRB to examine such offices and requires the FRB to coordinate the examination of all the

U.S. operations of a foreign bank;

- Permits sharing of supervisory information with foreign supervisors;
- Imposes a single borrower lending limit on state-licensed branches and agencies;
- Requires prior approval for the direct or indirect acquisition by a foreign bank of more than five percent of the shares of a U.S. bank;
- Establishes new restrictions on retail deposit-taking by branches and agencies of foreign banks; and
- Provides that state branches and agencies may not engage in any activity that is not permissible for federal branches, unless the FRB determines that the activity would be consistent with sound banking practices and, in the case of insured branches, the FDIC determines the activity does not pose a threat to the deposit insurance fund.

Effect on FDIC Operations

The most notable effects of the FBSEA are on the application and examination processes.

Applications. The legislation contains implications for applications by foreign entities for FDIC insurance for U.S. subsidiary banks. While the law does not specifically mention applications by foreign entities for subsidiary banks, the FRB intends to incorporate the mandatory and discretionary standards applicable to the establishment of a branch, agency, or commercial lending company into the subsidiary bank application approval process. Mandatory standards require that the foreign bank must be subject to comprehensive supervision by home country authorities on a consolidated basis and must supply any information to the FRB needed to adequately assess the application. Foreign banks must apply to the FRB to establish subsidiaries and review examiners assessing insurance applications for

these entities should consult with the FRB regarding its assessment of the adequacy of an entity's consolidated supervision.

Examinations. The legislation requires that U.S. branches and agencies for foreign banks be examined at least once in every 12 month period and requires the FRB to coordinate the examinations of U.S. operations of a foreign bank with federal and state regulators. Examinations of such entities should include steps to verify that the foreign bank is subject to consolidated supervision and that procedures for such that were evaluated as part of the approval process are in fact in operation.

Status

To implement the FBSEA provisions of FDICIA, the FRB issued regulations to amend Regulations K and Y on January 28, 1993. Interim regulations had been in place since April 4, 1992. However, further amendments to Regulation K to implement section 202 of FDICIA are not yet final.

Source

RD# 92-082 (7-15-82) Foreign Bank Supervision

Contact

Kathleen M. James, Examination Specialist, Office of Policy, (202) 898-6809, or by E-mail, Kathleen M. James@WEST@DBSWO.

Questions and Answers

Q. Does the Foreign Bank Supervision Enhancement Act provision of

FDICIA preclude foreign banks from establishing offices to accept retail deposits?

A. Section 214 of FDICIA amends section 6 of the International Banking Act of 1978 to state that, in order to accept or maintain deposit accounts having balances of less than $100,000, a foreign bank shall:

- establish 1 or more banking subsidiaries in the United States for that purpose; and
- obtain Federal deposit insurance for any such subsidiary in accordance with the Federal Deposit Insurance Act.

The law, in effect, closes the door to the establishment of foreign branches which conduct retail deposit-taking activities. Some confusion arose over the language used; while the title of the subsection was specific to retail deposit-taking, the text did not specify retail deposit-taking, but addressed deposit accounts having balances of less than $ 100,000. Clarifying language was contained in section 1604 of the Housing and Community Development Act of 1992. It specifically refers to domestic retail deposits and deposits of less than $100,000 and requiring deposit insurance protection.

The result is that foreign banks wishing to engage in domestic retail-deposit taking must do so through a subsidiary; with the exception being those branches which were insured prior to December 19, 1991. While it is unlikely that a foreign bank engaged in wholesale deposit-taking would want to apply for Federal deposit insurance, the law does not preclude such applications.

STOCK LOANS

Reporting Requirements

Purpose

Section 205 of FDICIA revises the provision of section 7(j)(9) of the FDI Act governing the reporting of extensions of credit secured by the stock of an insured depository institution. These reports are intended to assist the federal banking agencies in identifying situations where insured depository institutions have experienced a change in control without the filing of appropriate applications/notices by the new control person or group.

Summary

With certain exceptions, section 205 requires any financial institution that, together with its affiliates, has credit outstanding to any person or group of persons secured by 25 percent or more of any class of stock of an insured depository institution to file a report with that insured institution's primary federal banking agency. The lending financial institution must also file a copy of the report with its primary federal banking agency (if different from the insured institution's agency). Any stock held by the financial institution or any of its affiliates as principal must be included with the stock held as collateral for purposes of the 25 percent test.

The report(s) must be submitted within 30 days after the financial institution or any of its affiliates first believes the 25 percent reporting threshold has been reached. The report must indicate the number and percentage of shares of stock securing each extension of credit, the identity of each borrower, and the number

of shares held as principal by the lending financial institution and its affiliates. The federal banking agency recipients of these reports may request additional information.

The term "financial institution" is defined as any insured depository institution and any foreign bank that is subject to the provisions of the Bank Holding Company Act.

A lending financial institution is not required to file a report if the borrowing person or group has disclosed the borrowing to the insured institution's primary federal banking agency in connection with an application or Change in Bank Control Act notice that has been filed with that agency. In addition, reports are not required if the borrowing person or group has owned the stock for one year or more or if the stock is that of a newly chartered bank and was issued prior to its opening.

Status

The statutory requirements of section 205 took effect upon enactment. The requirements are self-explanatory and implementing regulations are not required.

Contact

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BRANCH CLOSINGS

Policy Statement

Purpose

Section 228 of FDICIA adds a new section 42 to the FDI Act that imposes notice and other requirements on insured depository institutions that intend to close a branch. These requirements are designed to inform the community and the Federal financial institutions regulatory authorities of an institution's intention to close a branch and the reasons therefor.

Summary

The FDIC Board of Directors has approved an interagency statement of policy, regarding notices of branch closing. The policy statement is intended to clarify questions relating to compliance with the statutory provisions.

The policy statement makes the following determinations:

- The term "branch" is defined to be a traditional brick-and-mortar branch at which deposits are received or checks paid or money lent. For purposes of section 42, the definition of branch does <u>not</u> include remote service facilities.
- The law does not apply to an interruption of service caused by a natural catastrophe.
- Mergers, consolidations, or other acquisitions, including branch sales, that do not result in branch closing do not trigger branch closing requirements.
- A change in services at a branch such that the remaining facility is still considered to be a branch (as defined in the policy statement) does not

require branch closing notices.

- Reduction of branch services to simply those provided by a remote service facility is considered a branch closing under the policy statement.
- A branch relocation is not a branch closing for purposes of section 42. A branch relocation is a movement within the same immediate neighborhood that does not substantially affect the nature of the business or customers served.
- Section 42 does not apply to the closing of a temporary branch.
- Section 42 does not apply to the transferring back to the FDIC or RTC, pursuant to the terms of an acquisition agreement, of a branch of a failed bank or savings association operated on an interim basis in connection with the acquisition of all or part of a failed bank or savings association.
- The consolidation of branches is not a branch closing if the branches are located within the same immediate neighborhood and the nature of the business or customers served is not substantially affected.

The law requires a notice of closing to the FDIC 90 days prior to the proposed branch closing. The notice must include the name of the branch involved, the intended date of closing, a statement of reasons for the closing, and statistical or other information in support of such reasons.

The statute also requires that an institution closing a branch provide notice to the customers of the branch 90 days prior to the closing date. Customers of a branch are those patrons identified in good faith through a method devised by the bank for allocating customers to a branch. A bank that allocates customers based on where the customers opened a deposit or loan account is presumed to have reasonably identified each customer of the branch.

The law requires the institution to post notice to branch customers in a conspicuous manner on the branch premises at least 30 days prior to the closing.

This notice should state the intended date of closing and identify where customers may obtain service following that date or provide a telephone number for customers to call to determine such alternate sites.

Each depository institution that has a branch must adopt a branch closing policy. The policy should be in writing and consistent with the size and needs of the institution.

Effect on Supervision Activities

Compliance with the branch closing requirements will be reviewed at each safety and soundness examination; however, the effect of the closing on the bank's CRA performance will be reviewed as part of the compliance examination. Notices received in the regional office will be reviewed for completeness and any additional documentation needed will be requested from the institution.

Status

The interagency policy statement became effective upon its publication in the Federal Register on September 21, 1993.

Sources

PR-142-92 (10-13-92)	FDIC Proposes Policy on Advance Notice by Banks of Plans to Close Branches
FIL-75-92 (10-23-92)	Proposed Policy on Advance Notice of Plans to Close Branches
PR-94-93 (8-10-93)	FDIC Adopts Policy for Advance Notice of Branch Closings
FIL-67-93 (9-24-93)	Interagency Policy Statement on Advance Notice of

	Branch Closings; Related FDIC request for Comment
RD# 93-145 (10-5-93)	Branch Closings Procedures

Contact

Curtis L. Vaughn, Examination Specialist, Office of Policy, (202) 898-6759, or E-mail, Curtis Vaughn@WEST@DBSWO.

Questions and Answers

Q. A bank wishes to relocate a branch outside of the neighborhood it currently serves. Must the bank meet the branch closing requirements?

A. Yes. Relocations have been defined as those moves within the same immediate neighborhood in which the nature of the business and customers served are not affected. Longer distance relocations are considered branch openings and closings. In rural areas, immediate neighborhoods are geographically larger than in more urban areas. Supervisory judgment will be necessary in each case to determine if branch closing policies should be followed.

Q. A bank's lease is terminated and it does not have time to comply with a 90-day prior notification requirement. May the bank make its best efforts to comply with the statute rather than giving a full 90-day notice?

A. Supervisory judgment is necessary in cases in which an institution contends that it cannot comply because of circumstances beyond its control. Each situation encountered will have its own nuances and should be considered in light of the circumstances and the institution's record of compliance with similar statutes.

Q. Pursuant to a merger, the acquiring institution wishes to close its branch in a small town by consolidating it with a branch of the acquired institution about 1 mile away. Must the institution file a branch closing notice?

A. Branch consolidations will be treated the same as relocations for purposes of complying with branch closing provisions if the consolidation is within the same neighborhood and the nature of the business and customers served are not changed. In rural areas, immediate neighborhoods are geographically larger than in more urban areas. Supervisory judgment will be necessary in each case to determine if branch closing policies should be followed.

BROKERED DEPOSITS

Final Rule

Purpose

Section 301 of the FDICIA amends Section 29 and adds section 29 A to the FDI Act, imposing restrictions on the use of brokered deposits by insured depository institutions. Because some troubled institutions have used brokered deposits to pursue rapid growth in an attempt to avoid insolvency, Congress mandated that only the best capitalized institutions could have unrestricted access to brokered deposits.

Summary

A "brokered deposit" is defined as any deposit obtained, either directly or indirectly, from or through a deposit broker. A deposit broker is any person who places or facilitates the placement of deposits with insured depository institutions.

The ability of a bank to accept brokered deposits is tied to its capital level. The FDIC on October 19, 1993 amended Part 337 of its regulations to reflect the capital level definitions for banks in the prompt corrective action (PCA) regulations. As a result, the capital category definitions for both the brokered deposit regulations and the PCA regulations are now the same. As a result:

- **Well capitalized banks** - those with a 10 percent risk-based capital ratio, 6 percent Tier 1 risk-based capital ratio, and 5 percent Tier 1 leverage ratio and not subject to any written agreement, order, or directive to meet and maintain a specific capital level for any capital measure - can accept brokered deposits without restriction.

- **Adequately capitalized banks** - those with at least a risk-based capital ratio of 8 percent, 4 percent Tier 1 risk-based capital, and 4 percent Tier 1 leverage ratio (or at least 3 percent if rated composite 1 under the CAMEL system) - may accept brokered deposits if they first obtain a waiver from the FDIC.

- **Undercapitalized banks** - those with less than an 8 percent risk-based capital ratio, 4 percent Tier 1 risk-based capital ratio, or 4 percent Tier 1 leverage ratio - are prohibited from accepting any brokered deposits. This restriction cannot be waived for undercapitalized institutions.

The restrictions on the acceptance of brokered deposits also apply to insured branches of foreign banks. The definitions of **"Well capitalized", "Adequately capitalized", and "Undercapitalized"** foreign branches are found in the prompt corrective action regulations at section 325.103(c).

Under the PCA regulations, the appropriate banking agency may, under certain circumstances, reclassify a well capitalized insured depository institution as adequately capitalized if it determines (after notice and opportunity for hearing) that the insured depository institution is in an unsafe or unsound condition or, pursuant to section 8(b)(8),[1] deems the institution to be engaging in an unsafe or unsound practice. As a result of conforming the definitions used in the brokered

[1]Section 8(b)(8) of the FDI Act provides that if an insured depository institution receives, in its most recent report of examination, a less-than-satisfactory rating for asset quality, management, earnings or liquidity, the appropriate federal banking agency may (if the deficiency is not corrected) deem the institution to be engaging in an unsafe or unsound practice.

deposit regulations to the definitions used in the PCA regulations, a well capitalized institution that is reclassified as adequately capitalized will be subjected to the brokered deposit provisions applicable to adequately capitalized institutions.

The PCA regulations also permit the appropriate federal banking agency to require an adequately capitalized or undercapitalized institution to comply with certain supervisory actions as if the institution were in the next lower category. Such actions are not treated as a reclassification for purposes of the brokered deposit regulations. Consequently, if the appropriate federal banking agency subjects an adequately capitalized insured depository institution to the PCA supervisory provisions applicable to the under-capitalized category, the institution will not be subjected to the undercapitalized capital category provisions of the brokered deposit regulations. The basis for this is that an adequately capitalized institution's access to brokered deposits is already strictly regulated by the brokered deposit statute and regulations and little would be achieved by subjecting an adequately capitalized institution to the prohibitions applicable to undercapitalized institutions.

The law also links the rate of interest an institution can pay for brokered deposits to a bank's capital position. No restrictions were placed on the rates of interest that may be paid by well capitalized institutions. Adequately capitalized banks may not pay more than 75 basis points higher than the local or national yields paid on deposits of comparable size and maturity. Undercapitalized banks, which cannot accept brokered deposits, are also prohibited from soliciting any deposits by offering rates more than 75 basis points above the prevailing yields in the bank's normal market area or in the market area in which deposits are being solicited.

Section 29 A of the FDI Act requires deposit bankers to file a notice with the FDIC and to maintain such records as FDIC may require by regulation.

Effect on FDIC Operations

Any FDIC insured adequately capitalized depository institution, regardless of supervisory authority, that wants to accept brokered deposits must obtain a waiver from the FDIC. The request for a waiver may be in letter form and filed with the appropriate FDIC regional director.

If an institution moves from a well capitalized to an adequately capitalized designation, there is no grace period during which the bank may accept, renew, or roll over brokered deposits while an application for a waiver from the FDIC is pending. The bank must immediately cease to accept, renew, or roll over brokered deposits until its application for a waiver has been approved by the FDIC.

Examination procedures for compliance with the law and regulation should include checking to see that bankers are registered with FDIC.

Status

The brokered deposit regulations became effective June 16, 1992. Effective November 24, 1993, the FDIC amended the regulations to conform the capital level definitions to those in the PCA regulations.

Sources

RD# 90-022 (1-29-90)	Applications to Waive the Prohibition on the Acceptance, Renewal or Rollover of Brokered Deposits - Processing Guidelines and Limited Delegation of Authority
FIL-3-92 (1-9-92)	New Limits on Brokered Deposits

FIL-31-92 (4-10-92)	Proposed New Limits on Brokered Deposits (Part 337)
PR-80-92 (5-20-92)	FDIC Issues New Rules Limiting Brokered Deposits, Certain Interest Rates
FIL-42-92 (6-3-92)	New Rules Limiting Brokered Deposits, Interest Rates (12 CFR 337.6)
FIL-43-92 (6-11-92)	Additional Information on New Rule Limiting Brokered Deposit, Interest Rates (Part 304)
RD# 92-76 (6-30-92)	Brokered Deposits - Revision of section 337.6 of FDIC Regulations
PR-38-93 (4-27-93)	FDIC Proposes to Revise Classifications Used in Brokered Deposit Rule
FIL-74-93 (11-3-93)	Revised Capital Category Definitions for Brokered Deposits Regulation (12 CFR 337.6)

Contacts

Valerie Jean Best, Counsel, Legal Division at (202) 898-3812 for legal interpretations or William G. Hrindac, Examination Specialist, Office of Policy, (202) 898-6892 or E-mail, William G. Hrindac, for policy issues.

Questions and Answers

Q. Since the brokered deposit regulation defines a deposit broker as any person engaged in the business of placing or facilitating the placement of deposits of third parties with insured depository institutions, would certificate of deposit (CD) listing services be considered "brokers?"

A. If the service only provides information to its subscribers on the availability, terms, and current interest rates of CDs, it would not be considered a deposit broker. If the listing service actually places deposits

or facilitates the placement of deposits of third parties with insured institutions, or places deposits with insured institutions in order to sell interests in those deposits to third parties, it would be considered a deposit broker. If the bank pays a fee to have its rates listed by the service or if the listing service actively provides names of depositors to the bank to facilitate the placement, the service is considered a "broker."

A deposit listing service **will not** be considered a deposit broker if it meets **all** of the criteria listed below:

- The person or entity providing the listing service is compensated only by subscription fees, and the fees are not based upon the number or dollar amount of deposits placed as a result of information provided by the listing service;
- The depository institution does not directly or indirectly pay a fee to have its rates listed by the listing service;
- The depository institution is not required to subscribe to the service or to purchase or participate in any other services or businesses offered by the listing service or any of its affiliates as a condition precedent to being listed, and the listing service does not guarantee that subscribers will have their rates published;
- The depository institution does not, directly or indirectly, pay a commission for deposits placed as the result of information provided by the listing service;
- The service provided is limited to the gathering and transmission of information concerning the availability of deposits;
- Any funds to be invested in deposit accounts are remitted directly by the depositor to the insured depository institution and not, directly or indirectly, through the person or entity providing the listing service; and,
- The listing service has no role in placing the deposits. For example,

if customers seeking to place deposits give the listing service their names and other information and the listing service passes that information on to a depository institution, that would be deposit brokering (even if the funds involved were sent directly from the customer buying a CD to the institution, without any other involvement by the listing service).

Q. The previous brokered deposit regulation provided that an undercapitalized insured depository institution could not offer a rate of interest more than 50 basis points higher than the prevailing rate on any deposit in the institution's market area. Under the new regulation, the allowable difference in rate of interest has been changed to 75 basis points. When a CD that was considered brokered under the old regulation matures, will it be considered brokered under the new regulation?

A. No. Deposits considered brokered under the previous regulation because they were at rates in excess of 50 basis points over the market will not be considered brokered when they are renewed, provided they meet the new guidelines.

Q. Several banks are involved in spread CD programs in which the depositor will approach the bank to obtain a CD in excess of $100,000 and the bank allocates the funds between a number of related institutions to ensure that the deposits are fully insured. Are these considered "brokered deposits?"

A. Yes, spread CD programs are considered brokered deposits unless they are operated by a trust department exercising its fiduciary responsibilities. However, only the portions of the deposit placed by the lead bank into other related institutions are considered brokered.

Q. If a bank moves from a well capitalized to an adequately capitalized designation, is there any grace period during which the bank may accept,

renew, or roll over brokered deposits while its application for a waiver is pending? Would they be violating the regulation the first time they accepted, renewed or rolled over a brokered deposit after their capital category changed?

A. No grace period is allowed. The bank is responsible for monitoring its capital to ensure that it is in compliance with the regulation. When a bank's capital category declines to adequately capitalized, it must immediately cease to accept, renew, or roll over brokered deposits until an application for a waiver has been approved by the FDIC. Until the application is approved, any brokered deposit activity would be in violation of the regulation. However, the FDIC may grant a temporary waiver based upon a preliminary review for a short period to facilitate the orderly processing of an application for a waiver.

Q. Under certain circumstances, the regulations define as brokered deposits deposits offered by financial institutions at rates of interest more than 75 basis points higher than the prevailing market rates. How will these deposits be handled for call report purposes? Will any deposit on which a bank pays more than 75 points over the prevailing market rate be considered a brokered deposit?

A. For call report purposes, brokered deposits have heretofore included only deposits obtained from or through the mediation or assistance of a third party. Other deposits, not defined as brokered, on which the interest rate is "significantly higher" than the prevailing rate of interest offered by similar type institutions were not included. However, the call report definitions have been changed to conform to the brokered deposits regulation effective with the March 31, 1993 call. Hence both types of deposits will be reported as brokered deposits in the future.

RISK-BASED ASSESSMENTS

Final Rule

Purpose

Section 302 of FDICIA amends section 7(b) of the FDI Act to require the FDIC to replace the flat-rate federal deposit insurance system with a risk-based assessment system. By linking the amount of deposit insurance premiums paid by insured institutions to the risks each institution poses to the insurance funds, the rule rewards well-run institutions and encourages weaker institutions to improve their condition.

Summary

To arrive at a risk-based assessment, the FDIC will place each bank and thrift in one of nine risk categories based on capital ratios and supervisory risk factors. Each institution will be assigned to one of three groups based on its capital ratios.

- **Capital Group One.** An institution that has at least a 10 percent total risk-based capital ratio, a 6 percent Tier 1 risk-based capital ratio, and a 5 percent Tier 1 leverage capital ratio.

- **Capital Group Two**. An institution that does not qualify for group one but which has at least an 8 percent total risk-based capital ratio, a 4 percent Tier 1 risk-based capital ratio, and a 4 percent Tier 1 leverage capital ratio.

- **Capital Group Three.** An undercapitalized institution will be one that does not meet either of the above definitions.

In addition to the capital category, each institution is assigned to one of three Supervisory Subgroups.

- **Subgroup A.** Consists of financially sound institutions with only a few minor weaknesses and generally corresponds to the primary federal regulator's examination composite rating of 1 or 2.

- **Subgroup B.** Consists of those institutions that demonstrate weaknesses which if not corrected could result in significant deterioration of the institution and increased risk of loss to the insurance fund and generally corresponds to the primary federal regulator's examination composite rating of 3.

- **Subgroup C.** Consists of institutions for which there is substantial probability of loss to the insurance fund unless effective corrective action is taken and generally corresponds to the primary federal regulator's examination composite rating of 4 or 5.

The Supervisory Subgroup assignments are based on supervisory evaluations by the institution's primary federal regulator and other factors including:

- results of the last examination completed and transmitted to an institution by the primary federal regulator;
- time elapsed since the last examination;
- results of off sight statistical analysis of reported financial statements; and
- other pertinent information.

Assessment rates paid by individual institutions depend on both the institution's capital group and its supervisory subgroup. The rate structure is reviewed periodically by the FDIC Board of Directors.

Assessment Rate Table (premium per $100 of domestic deposits)

	Supervisory Subgroup		
	A	**B**	**C**
Capital Group			
One	.23	.26	.29
Two	.26	.29	.30
Three	.29	.30	.31

Risk Related Premium Unit (RRPU)

The RRPU has been established in the DOS Analysis and Monitoring Section in Washington. RRPU is responsible for inputing data received from the primary federal regulator, preparing exception reports for institutions not assigned to either a Capital Group or Supervisory Subgroup category, and preparing reconcilement lists. These lists contain institutions whose preliminary supervisory subgroups may be in need of revision based on the results of current offsite analysis or differences in perception of risk profile that may exist between FDIC and other primary federal regulators. The majority of reconcilements are accomplished at the regional office level. The RRPU is also responsible for the administration of requests for review of either the Capital Group or Supervisory Subgroup assignment. However, some requests will be initially responded to by DOS regional offices.

Status

The FDIC published a transitional rule on October 1, 1992 and final rule on June 25, 1993. The final risk-related system becomes effective for the first semiannual assessment beginning January 1, 1994.

Sources

FIL-38-92 (5-27-92)	Proposal to Increase Bank and Thrift Insurance Fees Separate Proposal for Transitional Risk-Related Premium System
FIL-71-92 (10-7-92)	Risk-Based Premium System Starting in January, Higher Assessment Rates for Certain Banks and Thrifts
RD# 92-123 (10-15-92)	Risk-Related Premium System
FIL-77-92 (11-5-92)	Additional Information on the Implementation of Risk-Related Insurance Premiums
RD# 92-147 (12-1-92)	Procedures For Reviewing Assessment Risk Classifications and Supervisory Overrides - Risk Related Premium System (RRPS)
FIL-1-93 (1-11-93)	Comments Sought on Changes in Risk-Related Premium System for 1994
RD# 93-045 (3-23-93)	Risk-Related Premium System Assignment of Supervisory Subgroups
RD# 93-66 (4-27-93)	Summary Analysis of Examination Reports System
PR-45-93 (5-5-93)	FDIC To Send Insurance Refund Checks to Certain Banks and Thrifts that Improved Their Capital Positions
FIL-34-93 (4-30-93)	Risk-Related Premium System for the Assessment Period Beginning July 1, 1993
FIL-39-93 (5-26-93)	Revised Recapitalization Schedule for the Bank Insurance Fund (BIF): Deposit Insurance Assessment Rates for the Second Half of 1993
RD# 93-080 (5-28-93)	Procedures for Handling Request For Review of Supervisory Subgroup Assignments that Result from Differing Perceptions of Risk Profile Between FDIC and Other Federal Regulators

FIL-48-93 (7-2-93)	Modifications to the Risk-Related Premium System
FIL-47-93 (6-18-93)	Risk-Related Insurance Premiums for the Semiannual Period Beginning July 1, 1993
FIL-64-93 (9-9-93)	Risk Related Premium System for the Assessment Period Beginning January 1, 1994

Contacts

Contacts are Cary H. Hiner, Manager, Analysis and Monitoring Section at (202) 898-6814, G. Michael Dew, Chief, Risk Premium Unit, at (202) 898-7104, James W. Thornton, Examination Specialist, at (202) 898-6709 or Marianne Lester, Examination Specialist, at (202) 898-3528.

Question and Answer

Q. Will the slight differences in calculating risk-based capital by each of the three banking agencies cause differences in risk-based ratios, and thus different deposit premiums for similar banks?

A. No, for premium purposes the banking agencies have agreed upon a single method for measuring a bank's risk-based capital ratio -- the FDIC approach used in monitoring the PCA regulation. However, for thrifts the computations and rules are slightly different.

ACTIVITIES

Proposed Rulemaking

Purpose

Section 303 of FDICIA adds section 24 to the FDI Act. Section 24 in general prohibits an insured state bank and its subsidiaries from engaging after December 19, 1992 **as principal** in any type of **activity** that is not permissible for a national bank unless the FDIC has determined that the activity will pose no significant risk to the appropriate deposit insurance fund and the insured state bank is, and continues to be, in compliance with applicable capital standards prescribed by the appropriate Federal banking agency. The FDIC has issued a final regulation implementing the restriction on **equity investments** by State banks (see "Equity Investments" of this handbook).

Summary

The FDIC Board of Directors on January 12, 1993 approved a proposed rule governing activities of insured state banks. Banks that wish to engage in an activity not permissible for a national bank must meet applicable minimum capital standards and the FDIC must determine that the activity does not pose a significant risk to the fund. The proposed rule sets out application procedures for requesting the FDIC's consent.

Those institutions that were engaged in impermissible activities as of December 19, 1992 (the effective date of statutory restrictions on activities) were able to seek interim approval to continue the activity (see guidance issued in FIL-83-92.) The interim approval period expired on November 11, 1993. Those institutions that wish to engage in an activity which is not permissible for a national bank may

contact the regional office who will advise the bank of information to be submitted.

Effect on Supervision Activities

The prohibition relating to insured state banks engaging in activities not permissible for a national bank has been effective since December 19, 1992 and applies to both Federal Reserve member and nonmember state institutions. The FDIC does not yet have a final rule in place dealing with these restrictions. Until a final regulation is in place, any requests that must be processed should be forwarded to the Washington office for action. Enforcement of the statute should focus on the risk to the insurance funds from the continuation of an impermissible activity.

Status

The effective date of the statutory provisions relating to activities of insured state banks was December 19, 1992.

Sources

FIL-83-92 (11-27-92)	Interim Guidance Concerning Restrictions on Activities of FDIC-Insured State Banks
FIL-9-93 (2-4-93)	Proposed Restrictions on Activities of Insured State Banks
FIL-35-93 (5-10-93)	List of National Bank Activities and Equity Investments to Assist State Banks in Complying with New Restrictions
RD# 93-119 (8-5-93)	Interim Guidance Concerning Restrictions on Activities of FDIC-Insured State Banks

Contact

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Questions and Answers

Q. The FDIC already has a final regulation relating to equity investments which are not permissible for a national bank. Why is it necessary to have a regulation relating to activities which are not permissible for a national bank?

A. The current regulation, Part 362, relates only to those activities that are represented on a bank's books as an equity investment. This would include a bank's investment in a subsidiary but would not include the investments of a majority-owned subsidiary which are covered under the proposed activities restrictions. An activity of a bank includes acquiring or retaining any investment other than an equity investment. The proposed regulation is intended to cover those situations that the equity investment portions of Part 362 currently do not cover.

Q. How can I determine what is a permissible activity for a national bank?

A. National bank powers are not enumerated at any one place. Powers flow from the National Bank Act, regulations of the Comptroller of the Currency, and staff orders and interpretations. National bank powers may even flow from an institution which commenced an activity and no objection has been taken by the OCC. A complete list of national bank powers does not exist, nor is it contemplated that such a list will ever be formulated. However, the FDIC legal staff has compiled a partial list of National bank powers. If there is a question concerning activities permissible for a national bank, a bank should first rely on its own counsel

to make a determination concerning permissibility. An examiner should review the bank's research and, if necessary, consult with FDIC regional counsel.

Q. Are a bank's activities conducted as agent, such as insurance agency, real estate brokerage, securities brokerage or travel agency, covered under the statute?

A. No. The statute requires that an insured state bank may not engage as principal in any type of activity that is not permissible for a national bank. The proposed regulation states that an activity is considered to be conducted as principal if it is conducted other than as agent for a customer, is conducted other than in a brokerage, custodial or advisory capacity, or is conducted other than as trustee. This definition of "as principal" contrasts to earlier restrictions on savings associations which included agency activities within the scope of the restrictions of section 28 of the FDI Act. This difference is expected to be reconciled later as amendments to section 303.13 of the Corporation's regulations. Unless there is a significant safety and soundness concern, interim notices received concerning activities as agent should be held without any further action.

Q. May a bank hold real estate for investment purposes in its majority-owned subsidiary?

A. The proposed regulation sets out an application procedure that can be used for such activities as investment in real estate in a subsidiary. Until the time this application procedure is adopted, no final determination will be made by DOS concerning real estate investment holdings in a subsidiary unless safety and soundness concerns are of such a magnitude as to require formal enforcement action. Banks which continue to acquire and develop property in this interim period are taking a chance that such activities will

ultimately be ruled as not having a significant risk to the insurance funds. Until such activities have been reviewed on a case-by-case basis, the FDIC will not offer an opinion relating to the risk of such ventures to the insurance funds.

EQUITY INVESTMENTS

Final Rule

Purpose

Section 303 of FDICIA adds a new section 24 to the FDI Act. Section 24 requires that an insured state bank may not acquire or retain an equity investment of a type or in an amount that is not permissible for a national bank unless one of the statutory exceptions apply. Section 303 also limits activities of state chartered banks (see "Activities" in this handbook.)

Summary

The FDIC Board of Directors has approved a final rule Part 362, implementing the statutory restrictions on equity investments effective on December 9, 1992. No insured state bank (both Federal Reserve member and nonmember) may directly or indirectly acquire or retain any equity investment of a type, or in an amount, that is not permissible for a national bank except they are **not prohibited from**:

- Acquiring or retaining a majority interest in a subsidiary;
- Investing as a limited partner in a partnership the sole purpose of which is direct or indirect investment in the acquisition, rehabilitation, or new construction of a qualified housing project designed to primarily benefit lower income persons, provided that the investment does not exceed 2 percent of the bank's total assets;
- Owning stock in a savings bank life insurance company if the insured state bank is located in New York, Connecticut or Massachusetts;
- Owning common or preferred stock listed on a national securities

exchange or shares of a registered investment company if the bank is located in a state which as of September 30, 1991 authorized such investments, the bank made or held such investments during the period September 30, 1990 to November 26, 1991, the bank has filed a one-time notice with the FDIC concerning such investments, and the FDIC has determined that the investments pose no significant risk to the insurance funds;

- Acquiring up to 10 percent of the voting stock of a company that solely provides or reinsures directors and officers liability insurance coverage or bankers blanket bond group insurance coverage for insured depository institutions;
- Acquiring or retaining the voting shares of what is essentially a bankers bank (see definition in the statute); and
- Retaining its equity investment in a majority-owned subsidiary that was lawfully providing insurance as principal on November 21, 1991. ("Grandfathered insurance activity").

An equity investment acquired prior to the FDICIA effective date of December 19, 1991, that is not of a type, or in an amount permissible for a national bank, must be divested as quickly as prudently possible but no later that December 19, 1996. A bank that is required to divest must submit a divestiture plan to the regional director.

The ownership of common or preferred shares listed on a national securities exchange or shares of a registered investment company in no event shall exceed 100% of the bank's Tier 1 capital. Lower limits may be set by the FDIC. Generally, for banks that are less than adequately capitalized, these limits should not exceed highest aggregate level of investment during the period of September 30, 1990 to November 26, 1991 expressed as a percentage of the bank's Tier 1 capital. If a bank held such stock and/or shares on December 19, 1993 in excess

of 100% of capital, it must divest shares in excess of 100% of capital by an amount of at least 1/3 of excess investment each year in order that the bank complies with the maximum permissible investment by December 19, 1994.

Banks that are engaging in exempt insurance underwriting activities shall submit a notice of such activities within 60 days after December 9, 1992.

Effect on Supervision Activities

The new regulation creates three new types of notices to the FDIC:

- a one-time notice of the bank's intent to continue its investment in common or preferred shares or shares of a registered investment company;
- divestiture plans for existing equity investments which do not comply with the provisions of this regulation; and
- a notice of "grandfathered" insurance underwriting activities and an application for a bank that is less than well-capitalized to continue a grandfathered insurance activity if it expects to meet required capital levels within 3 years.

Authority has been delegated to the DOS regions to determine if a bank's investment in common or preferred shares or shares of a registered investment company presents a significant risk to the fund and to impose conditions on the conduct of this activity. Negative determinations or conditions imposed which are not agreed to by the applicant shall be referred to the Director, DOS.

Authority is delegated to the DOS regions to accept divestiture plans without modification or to approve divestiture plans with modifications and conditions agreed to by the bank. Divestiture plans not approved by the Regional Director or modified in a manner with which the bank does not agree should be forwarded

to the Director, DOS.

Insurance notices require no approval action. Authority is delegated to the DOS regions to approve applications for grandfathered insurance activities by less than well-capitalized banks. Recommendations for denial should be forwarded to the Director, DOS.

In reviewing a bank's investment portfolio, examiners should determine if investments are permissible for a national bank, assure that proper notices have been filed, and determine that the bank is abiding by the provisions of any divestiture plans filed. Examiners may contact the regional office to determine permissibility of specific equity investments.

Status

The effective date of the statutory equity investment provisions was December 19, 1991. Because the FDIC was delayed in issuing its final regulations implementing the statutory provisions, judgment should be used in determining what action, if any, is to be taken in connection with the purchase of impermissible investments from the effective date of the statute until the effective date of the regulation on December 9, 1992.

Sources

FIL-52-92 (7-15-92)	Proposed Restrictions on Equity Investments of State Banks
FIL-80-92 (11-13-92)	Final Rules Implementing Restrictions on State-Chartered Banks (Parts 362 and 333)
RD# 92-144 (11-20-92)	Implementation of Part 363 - "Activities and Investments of Insured State Banks".

FIL-35-93 (5-10-93) List of National Bank Activities and Equity Investments to Assist State Banks in Complying with New Restrictions

Contact

Curtis L. Vaughn, Examination Specialist, Office of Policy, (202) 898-6759, or by E-mail, Curtis Vaughn@WEST@DBSWO.

Questions and Answers

Q. How can I determine what is a permissible equity investment for a national bank?

A. National bank powers are not enumerated at any one place. Powers flow from the National Bank Act, regulations of the Comptroller of the Currency, and staff orders and interpretations. National bank powers may even flow from an institution which commenced an activity and no objection has been taken by the OCC. A complete list of national bank powers does not exist, nor is it contemplated that such a list will ever be formulated. However, the FDIC legal staff has compiled a partial list of National bank powers which may be used as a resource document but should not be considered to be a comprehensive list. If there is a question concerning activities permissible for a national bank, a bank should first rely on its own counsel to make a determination concerning permissibility. Examiners may review the bank's research or consult with FDIC regional counsel.

Q. The regulation provides no due date for the one-time notice relating to continuation of investments in common or preferred shares or shares of a registered investment company. How long does a bank have to submit this notice?

A. The one-time notice is required by statute for an institution which after December 19, 1991 wishes to acquire or retain ownership of common or preferred shares or shares of a registered investment company. Many banks delayed submitting such notices until the effective date of the FDIC regulation. Notices should be submitted as promptly as possible. Instances in which equity investments were acquired or retained after December 19, 1991 without the institution giving proper notice will be dealt with on a case-by-case basis.

Q. A bank has an investment in a mutual fund which invests only in United States government securities. Is this a permissible investment for a national bank?

A. Yes. National banks may purchase and hold investment company shares without limitation, if the portfolio of such an investment company consists wholly of investments in which the national bank could invest directly without limitation.

Q. Does a bank's investment in mutual funds which are permissible for a national bank count towards the total investment limit on common and preferred shares and shares of a registered investment company?

A. No. Since the investments are permissible for a national bank, the only limitations on holding these assets would be national bank limits on the holding of such assets or any applicable state limitations. The investment limits contained in Part 362 cover only the investment in shares that would not be permissible for a national bank.

Q. A bank holds an equity interest in a real estate construction project. Is it permissible for the bank to advance additional funds to the project to complete construction?

A. Such requests should be made in conjunction with a viable divestiture

plan. If the most reasonable method of divestiture would involve completion of the project and the bank has been the only viable source of funds for the project, the regional office may in its discretion, subject to other safety and soundness considerations, allow further advances on the project.

Q. May equity interests in real estate held directly by the bank be transferred to a subsidiary?

A. Yes, but only with the prior consent of the FDIC. As the FDIC has yet to complete rules concerning equity investments in real estate in a subsidiary, applications to do so cannot be resolved in the region.

Q. Does this rule implement all the provisions of section 24 of the FDI Act?

A. No. The FDIC has a separate proposal which covers activities and investments which are not equity investments conducted directly in the bank and activities of a majority-owned subsidiary.

REAL ESTATE LENDING STANDARDS

Final Rule

Purpose

Section 304 of FDICIA adds section 18(o) to the FDI Act and requires the federal bank and thrift regulatory agencies to adopt uniform lending standards for extensions of credit that are: (1) secured by liens on or interests in real estate, or (2) made to finance the construction of a building or other improvements to real estate, regardless of whether a lien has been taken on the property. In developing the standards, the agencies were required to consider the risk posed to the deposit insurance funds by such extensions of credit, the need for safe and sound operation of insured depository institutions, and the availability of credit.

Summary

The final rule requires insured depository institutions to adopt and maintain written real estate lending policies that are appropriate to the bank's size and nature and scope of operations. The policies must be reviewed and approved by the bank's board of directors at least annually. Real estate lending policies must be consistent with safe and sound banking practices and must include:

- Loan portfolio diversification standards;
- Prudent underwriting standards, including loan-to-value limits, that are clear and measurable;
- Loan administration policies; and,
- Documentation, approval, and reporting requirements for monitoring compliance with the bank's real estate lending policies.

The regulation requires each bank to monitor real estate market conditions in its lending area to ensure that its lending policies continue to be appropriate for current market conditions. The regulation also provides that the policies established by the bank **should reflect consideration of** the "Interagency Guidelines for Real Estate Lending Policies" adopted in conjunction with the final rule. These guidelines describe the factors that the agencies expect insured institutions to consider when establishing their real estate lending policies. However, it is management's responsibility to decide which factors are relevant for their institution and how those factors should be included in their lending policies.

Appendix A - Interagency Guidelines for Real Estate Lending Policies

The guidelines are intended to assist institutions in the development of a real estate lending policy that is appropriate to the size of an institution and the nature and scope of operations. The guidelines identify fundamental portfolio management, underwriting and loan administration issues that should be considered. Not all of the factors raised in the guidelines are relevant to every institution. Small banks, for example, which offer only basic real estate lending services, may need to address only a limited number of factors for their operations. Larger institutions generally will find that more of the factors apply to their operations. In all cases, however, institutions should develop a policy that is tailored to their operations. Moreover, the level of detail required generally depends on the organization structure of the institution, including where responsibility for complying with the policy is assigned.

Status

Part 365 of the FDIC's Rules and Regulations appeared became effective on March 19, 1993.

Sources

FIL-56-92 (7-22-92)	Interagency Proposal for Uniform Real Estate Lending Standards (Part 365)
FIL-2-93 (1-12-93)	New Standards for Prudent Real Estate Lending (Part 365)
RD# 93-23 (2-9-93)	Part 365 - Real Estate Lending Standards

Contact

Robert W. Walsh, Examination Specialist, Office of Policy (202) 898-6911 or by E-mail Robert W. Walsh@WEST@DBSWO.

Questions and Answers

Q. What are the guidelines for loan-to-value ratios?

A. The supervisory loan-to-value limits are:

Loan Category	Loan-to-Value Limit (in percentages)
Raw Land	65
Land Development	75
Construction:	
Commercial, Multifamily, and other Nonresidential	80
1- to 4-Family Residential	85
Improved Property	85
Owner-occupied 1-to 4-family and home equity	

Multifamily construction includes condominiums and cooperatives.

A loan-to-value limit has not been established for permanent mortgage or home equity loans on owner-occupied, 1- to 4-family residential property. However, for any such loan with a loan-to-value ratio that equals or exceeds 90 percent at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral. Improved building lots (i.e. lots with roads, sewers utilities or other improvement necessary before construction can begin) are included in the land development (or 75%) LTV category.

Q. How is the appropriate maximum loan amount calculated when the loan is cross-collateralized by two or more properties?

A. The LTV limit is the sum of the value of each property multiplied by the appropriate LTV limit for each property, less any senior liens.

Q. How is the basket for loans in excess of the supervisory LTV limits divided?

A. The guidelines recommend that the aggregate of all loans that exceed the supervisory LTV limits should not exceed 100 percent of total capital. Within that basket, a sublimit of 30 percent of total capital is also recommended for the aggregate of the following loans:

- Raw land with a LTV ratio above of 65%
- Commercial land development with a LTV ratio above 75%
- Commercial, multifamily and other nonresidential construction with a LTV ratio above 80%
- Improved property with a LTV ratio above 85%

The remaining 70 percent of the basket (or up to 100% if loans in the foregoing group do not exhaust the full 30% sublimit) is available for the following kinds of loans for 1-to-4 family residential property including:

- Land development loans that exceed 75% LTV;
- Construction loans above 85% LTV;
- Loans on non owner occupied property above 85% LTV;
- Permanent mortgages and home equity loans on owner-occupied property that is equal to or exceeds 90% LTV without mortgage insurance or readily marketable collateral.

By adopting guidelines instead of a rigid regulation, the agencies are permitting individual lending institutions the flexibility to establish policies that are prudent for their own operating environment. Thus, individual institutions can adopt policies including LTV limits that exceed those recommended in these guidelines as long as they are prudent and properly supported by other credit factors.

Concentration of Credit and Nontraditional Activities

Proposed Rule

Purpose

Section 305 of FDICIA requires the FDIC and the other Federal regulators to revise their risk-based capital standards for insured depository institutions to ensure that those standards take adequate account of interest rate risk, concentration of credit risk, and the risks of nontraditional activities. Section 305 is intended to ensure that the risk-based capital standards for insured depository institutions require sufficient capital to facilitate prompt corrective action as well as to prevent or minimize loss to the deposit insurance fund.

Summary

On August 10, 1992, the FDIC, the Federal Reserve and the Office of the Comptroller of the Currency issued a joint advance notice of proposed rulemaking soliciting comments on a proposed framework for revising the risk-based capital standards to take adequate account of interest rate risk, concentration of credit risk and the risks of nontraditional activities as required by section 305 of FDICIA. (The Office of Thrift Supervision sought advance comment in a separate notice.) The comment period closed on October 9, 1992. The agencies developed two separate proposals; one involving interest rate risk (discussed elsewhere in this handbook) and one involving concentration of credit risk and the risks of nontraditional activities.

This latter proposal cites concentration of credit risk and the risks of nontraditional activities, as well as an institutions's ability to manage these risks,

as important factors in assessing an institution's overall capital adequacy. No mathematical formulas or explicit capital requirements are incorporated in the proposal due to practical and theoretical problems in quantifying these risks.

Concentration of credit risk typically refers to situations when a lender has a relatively large portion of loans to a particular borrower, industry, location, collateral or loan type. Nontraditional activities are considered those not traditionally part of the banking business but that are being conducted principally as a result of recent developments in technology and financial markets. Under the proposal, as an institution begins to engage in or significantly expand its participation in a nontraditional activity, the FDIC would promptly analyze the risks in the activity and give appropriate capital and supervisory treatment.

Effect on FDIC Operations

Currently, the FDIC and the other federal regulators, address capital adequacy through a variety of supervisory actions and consider these two risks in taking those varied supervisory actions. The principle impact of this proposal is to provide an explicit regulatory statement that these two risks will be considered when assessing an institution's overall capital adequacy.

Status

Final regulations were to be published not later than 18 months after the date of enactment of FDICIA, or June 19, 1993. The FDIC Board approved a notice of proposed rulemaking on May 11, 1993. An interagency notice, to be published in the Federal Register, has been delayed and is expected shortly.

References

FIL-60-92 (8-20-92)	Request for Comment on Possible Standards for Interest Rate Risk, Concentration of Credit Risks and Nontraditional Activities
PR-52-93 (5-11-93)	FDIC Proposes Capital Rule Revisions Addressing Risks of Concentrations of Credit and "Nontraditional" Activities

Contacts

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Question and Answer

Q. When will final regulations be issued?

A. At this time, early 1994 appears to be a reasonable estimate. The four agencies will authorize publication of a joint notice of proposed rulemaking in the Federal Register. Written comments on the proposed rule will be considered after publication. Final regulations will be issued after the four agencies have considered the written comments received.

Interest Rate Risk

Proposed Rule

Purpose

Section 305 of FDICIA requires the FDIC and the other Federal regulators to revise their risk-based capital standards for insured depository institutions to ensure that those standards take adequate account of interest rate risk, concentration of credit risk, and the risks of nontraditional activities. Section 305 is intended to ensure that the risk-based capital standards for insured depository institutions require sufficient capital to facilitate prompt corrective action as well as to prevent or minimize loss to the deposit insurance fund.

Summary

On August 10, 1992, the FDIC, the Federal Reserve and the Office of the Comptroller of the Currency issued a joint, advance notice of proposed rulemaking soliciting comments on a proposed framework for revising the risk-based capital standards for insured depository institutions to take adequate account of interest rate risk, concentration of credit risk and the risks of nontraditional activities as required by section 305 of FDICIA. (The Office of Thrift Supervision ("OTS") sought advance comment in a separate notice.) The comment period closed on October 9, 1992. Based on the comments received, the agencies developed two separate proposals; one regarding concentration of credit risk and the risks of nontraditional activities (discussed elsewhere in this handbook) and one regarding interest rate risk.

On September 14, 1993, the three banking agencies published a notice of proposed rulemaking in the Federal Register. Under the proposal, exposures to

interest rate risk would be measured as the change in the net economic value of an insured institution for a specified change in market interest rates. To measure this exposure, a supervisory model would be used. Alternatively, an insured institutions's internal model could be used when available and approved as adequate through the examination process. Institutions that have an interest rate risk exposure exceeding a supervisory threshold would be determined to have excessive risk in this area.

Two methods are proposed for determining what amount of additional capital, if any, an insured institution may be required to have if it has excessive interest rate risk exposure. Before determining compliance with capital regulations, one method would reduce an institution's risk-based capital ratios by an amount based on its measured interest rate risk exposure in excess of a supervisory threshold. The second method would determine a required amount of additional capital on a case-by-case basis, considering both the results of the model and the qualitative risk factors. To minimize the reporting and other regulatory burdens associated with this proposal, a quantitative screen is proposed that would exempt from additional reporting requirements those institutions identified as having potentially low interest rate risk.

The OTS has adopted an alternative method for measuring the IRR exposures of savings associations which differs from that proposed by the three banking agencies (see the Federal Register 57 FR 40524, September 3, 1992). Under the OTS method, savings associations report weighted average coupon and weighted average maturity information for various classes of assets, liabilities and off-balance-sheet instruments. For certain instruments, mortgage-related instruments in particular, the amount of information reported is significantly more detailed than that proposed by the banking agencies.

The OTS model uses two valuation methodologies: (1) a static discounted cash

flow analysis similar to that proposed by the banking agencies, and (2) an option-based pricing model (also known as an option-adjusted spread or OAS methodology) for valuing certain assets, such as mortgages and mortgage-related instruments, that contain embedded options. The banking agencies have requested comment on the use of the OTS model for banks that have balance sheets similar to savings associations.

Effect on FDIC Operations

The instructions for implementing the final rule that is adopted will be incorporated into the FDIC's safety and soundness examination procedures. The proposal is intended to identify insured institutions with high levels of interest rate risk. Because many features of the proposal may be subject to change before a final rule is adopted, it is premature to speculate on its potential impact on any particular insured institution. However, whatever proposal is finally adopted, the amount of capital required would represent the minimum capital requirement for interest rate risk, assuming that adequate internal controls and management were in place. This proposal is not intended to replace other, more sophisticated procedures that institutions may use in their asset and liability management process.

Status

The comment period on the notice of proposed rulemaking ended October 29, 1993. Final regulations were to be published in the Federal Register not later than June 19, 1993. After the written comments have been carefully considered, the regulators will publish final regulations in the Federal Register.

Contacts

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Questions and Answers

Q. Should insured institutions start to make programming changes to conform with the sample reporting form that was included in the notice of proposed rulemaking?

A. No. It is premature to start making programming changes in anticipation of a regulatory measurement system. Many, if not all aspects of the proposal are subject to change. For this reason, the FDIC does not recommend that institutions make changes to their data and reporting systems. An institution's management can, however, review the adequacy of their funds management policies and reporting systems to ensure that the asset/liability management policy approved by the Board and the outstanding information systems meet the current needs of the institution. For example, does the Board's asset/liability management policy capture the institution's significant sources of interest rate risk and does the management information system clearly identify the levels of risk being taken and the institution's compliance with established policies and limits?

Q. Section 305 of FDICIA states that final regulations are to be published in the Federal Register not later than 18 months after the date of enactment of this Act. Does this mean that final regulations will be retroactive to June 19, 1993?

A. No. The statute gives the agencies the flexibility to "adopt reasonable transition rules." The FDIC recognizes that if a regulatory measurement

system is adopted, many institutions may need to make some programming changes to their data systems to provide the necessary information. It is anticipated that some kind of a transition period will be considered although the specific time has not as of yet been determined.

Q. Will the final rule require organizations to file reports on a system-wide basis?

A. The proposal states that data will be collected and risk measured for individual banks. Revising existing Call Report forms may be one way of gathering the necessary data. The proposal, however, has requested comment as to what extent the regulators also should consider consolidated positions of the parent holding company or, alternatively, the aggregate position of only its affiliated banks.

LOANS TO INSIDERS

Final Rule

Purpose

Section 306 of FDICIA amends section 22(h) of the Federal Reserve Act and also places additional restrictions on loans to executive officers and directors of banks.

The amendments require the Federal Reserve Board to issue final rules amending their Regulation O governing loans to insiders (executive officers, directors, and principal shareholders and their related interests) of banks and their holding companies.

Summary

The Federal Reserve issued final regulations implementing revisions to Regulation O on April 22, 1992 and May 28, 1992. The FDIC issued final revisions to Section 337.3 on May 18, 1992 and May 28, 1992.

FDIC Regulations. The major changes to Section 337.3 are:

- Allows "other purpose loans" to executive officers to a limit which is 2.5 percent of unimpaired capital and surplus, but in no event greater than $100,000;
- Exempts "education loans" and "home loans" from this limitation;
- Permits a one year period from the effective date of the regulation to bring extensions of credit into compliance; and
- Imposes additional reporting requirements, with the Call Report and to the bank's board of directors.

Extensions of credit made before May 28, 1992, may be repaid according to their repayment schedule. Renewals of existing extensions of credit that would be in excess of the allowed limit after May 28, 1992, may be extended for not beyond one year from the effective date of the amendment. All other extensions of credit must be made in accordance with section 337.3.

FRB Regulations. The major changes to Regulation O are as follows:

- Loans to insiders must be made with credit underwriting standards not less stringent than other loans;
- Directors and their related interests are now subject to individual lending limits;
- An aggregate lending limit on the total amount a bank can lend to its insiders and their related interests as a class was imposed;
- All companies that own banks are now covered by Regulation O, regardless of whether the company is technically a bank holding company; and
- Insiders are prohibited from knowingly receiving an unauthorized extension of credit.

The new aggregate lending limit, now applied to all insiders as a class, is 100 percent of a bank's unimpaired capital and surplus. This means that the total of all extensions of credit to executive officers, directors, principal shareholders, and all of their related interests combined cannot exceed the bank's unimpaired capital and surplus. However, exercising its discretion provided by FDICIA, the Federal Reserve approved a 200 percent limit for banks with total deposits of less than $100 million, provided the bank's board of directors makes certain attestations. The Board approved this higher limit for small banks until November 18, 1993, to give it more time to collect data to determine if the higher limit should be made

permanent.

The effective date of the amendments to Regulation O was May 18, 1992. Extensions of credit made on or before May 18, 1992, are not required to comply with the single borrower limit that now applies to directors and their related interests, or with the aggregate limit on loans to all insiders and their related interests. All extensions of credit made after May 18, 1992, must comply with all provisions of the statute and Regulation O. Renewals of existing extensions of credit are considered an extension of credit for Regulation O.

Status

The effective date of the amendments to Regulation O was May 18, 1992. The effective date of the amendments to section 337.3 was May 28, 1992.

Sources

FIL-18-92 (3-10-92) Section 22 (g) Federal Reserve Act -- Limitations on Loans to Executive Officers under Regulation O Now Applicable to Officials of State Non-member bank.

FIL-32-92 (5-5-92) Final Rule on Loans to Executive Officers for Purposes Other than an Education or a Home (Part 337).

RD# 92-67 (5-7-92) Amendments to Regulations on Loans to Insiders

Contact

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Questions and Answers

Q. Do Regulation O and section 337.3 exclude from their lending limits any extensions of credit exempted from the lending limits outlined in the National Bank Act, such as loans secured by own bank deposits?

A. No. According to the Federal Reserve Board, the definition of extension of credit in Regulation O does not provide similar exemptions. Recent legislation has recognized this problem and the Federal Reserve Board has proposed a change to eliminate the inconsistency.

Q. How does Regulation O define "unimpaired capital and surplus?"

A. Regulation O defines unimpaired capital and surplus as the sum of:

- Total equity capital reported on bank's most recent call report;
- Any subordinated notes and debentures approved as an addition to the bank's capital structure by its appropriate regulator;
- Any valuation reserves created by charges to the bank's income reported on its most recent call report.

Q. Does the section 337.3 limit on loans to executive officers include loans to their related interests?

A. The limit included in section 337.3 covers extensions of credit to executive officers only. Loans to their related interests would be included only if the executive officer endorses or guarantees the related interest's extensions of credit.

INTERBANK LIABILITIES

Final Rule

Purpose

Section 308 of FDICIA adds a new Section 23 to the Federal Reserve Act designed to limit the credit and settlement risks posed to insured depository institutions by the failure of a large depository institution.

Summary

Section 308 of FDICIA requires the Federal Reserve Board to develop regulations to limit the exposure of insured depository institutions to other depository institutions with which they do business (correspondents). The Federal Reserve Board's final Regulation F, "Limitations on Interbank Liabilities, was published in the Federal Register on December 18, 1992.

The final rule generally requires banks, savings associations, and insured branches of foreign banks (referred to collectively in the rule as "banks") to establish and maintain written policies and procedures ("prudential standards") to prevent excessive exposure to any individual correspondent in relation to the condition of the correspondent. These written policies and procedures must be in place by June 19, 1993 and reviewed and approved by the bank's board of directors at least annually thereafter.

In addition, a bank must limit its interday credit exposure to an individual correspondent to not more than 25 percent of its total capital unless it can demonstrate that the correspondent is at least adequately capitalized as defined in the rule. This 25 percent limit for less-than-adequately-capitalized

correspondents, is phased in so that from June 19, 1994 through June 18, 1995, the limit is 50 percent of the bank's total capital. The 25 percent credit limit becomes effective as of June 19, 1995.

Credit exposure to a correspondent generally includes claims on a correspondent that qualify as assets and off-balance sheet items subject to capital adequacy requirements. For example, such claims include demand deposit balances, Fed funds sales, and interest rate contracts. Credit exposure does not include exposure related to the settlement of transactions, intraday exposure, transactions in an agency or similar capacity or other sources of exposure that are not covered by capital adequacy guidelines.

In calculating credit exposure, a bank may exclude the following:

- Transactions that are fully secured by government securities or readily marketable collateral;
- Proceeds of checks and other cash items deposited in an account at a correspondent that are not yet available for withdrawal;
- Quality assets on which the correspondent is secondarily liable, or an obligation on which a creditworthy obligor in addition to the correspondent is available; and
- The portion of the bank's credit exposure to the correspondent that is covered by federal deposit insurance.

Transactions covered by netting agreements that are valid and enforceable may be netted in calculating exposure.

Effect on FDIC Operations

A bank subject to FDIC supervision should be able to demonstrate that it has

instituted "prudential standards" for establishing internal exposure limits and that it is monitoring the settlement and credit risk exposure to individual correspondents based on an analysis of each bank's creditworthiness.

Status

Regulation F (12 CFR Part 206), the Federal Reserve Board's final rule to implement section 308, was adopted in November 1992. "Prudential standards" requirements become effective June 19, 1993. There will be a phase-in period for credit exposure limits beginning June 19, 1994. Common interagency examination procedures are under development.

Sources

RD# 93-16 (2-3-93)	Interbank Liabilities
FIL-10-93 (2-5-93)	Limitations on Interbank Liabilities

Contact

William G. Hrindac, Examination Specialist, Office of Policy, (202) 898-6892 or E-mail, William G. Hrindac.

Questions and Answers

Q. What are the transition provisions of Regulation F?

A. Only the "prudential standards" provisions (section 206.4) of the regulation become effective June 19, 1993. The limits on credit exposure have a transition period before becoming fully effective. At the end of the first year, on June 19, 1994, credit exposure limits based on the capital position of the correspondent will be implemented at twice the final

amount. Thus exposure to correspondents that are not well capitalized or adequately capitalized will be limited to 50 percent of capital the first year (June 19, 1994 through June 18, 1995) and decline to 25 percent when the limits become fully effective on June 19, 1995.

Q. How will the exposure of bank subsidiaries to correspondents be treated?

A. A bank will have to include the credit exposure of its subsidiaries in calculating its credit exposure to a correspondent.

Q. How does Regulation F relate to commonly-controlled depository institutions?

A. A bank does not need to limit its credit or other exposure to a correspondent that is commonly controlled with the bank and for which the bank is subject to cross-guaranty liability under section 5(e) of the FDI Act.

Q. What if a bank cannot obtain necessary services by complying with the "prudential standards" for credit exposure?

A. The Federal Reserve Board can waive the applicable requirements of section 206.4(a) for a bank if the appropriate federal banking agency advises the Board that the bank cannot otherwise reasonably obtain necessary services.

DEPOSIT INSURANCE

Final Rule

Purpose

Section 311 of FDICIA amends section 11 of the FDI Act, changing the rules governing insurance coverage of certain retirement and other employee benefit plan deposits as well as the rules governing insurance coverage for accounts where an insured institution is acting in a fiduciary capacity (e.g., as agent, custodian nominee, trustee, or guardian).

Summary

The insurance coverage rules for retirement and employee benefit plan deposits were changed in the following ways:

- An individual's vested interests in all Individual Retirement Accounts (IRAs), self-directed Keogh Plan accounts, "457 Plan" accounts, and self-directed defined contribution pension plan accounts maintained at the same institution will be aggregated and insured in total to $100,000, assuming the accounts qualify for "pass-through" insurance according to the rules in the next paragraph. (A "457 Plan" accounts is a type of deferred compensation plan which qualifies under section 457 of the Internal Revenue Code. It is established by state and local governments or by not-for-profit organizations for their employees.) This change is effective December 19, 1993.

- Deposits of employee benefit plans, i.e., those plans that qualify under section 3(3) of the Employee Retirement Income Security Act of 1974

(ERISA) and Keogh Plans, including not only defined contribution and defined benefit plans but also certain employee welfare benefit plans, are entitled to "pass-through" or per-participant insurance coverage only if the institution receiving such deposits was permitted to accept brokered deposits at the time the plan deposits were accepted. Thus, benefit plan deposits in well-capitalized institutions and adequately-capitalized institutions that have received a waiver from the FDIC to accept brokered deposits are entitled to pass-through insurance coverage. Benefit plan deposits in undercapitalized institutions are not entitled to pass-through insurance coverage. Benefit plan deposits in adequately capitalized institutions which have not applied to the FDIC for a waiver to accept brokered deposits, or which applied and were denied a waiver, may still qualify for pass-through coverage if such institutions meet every applicable risk-based and leverage capital standard and provide plan depositors with a written statement indicating that their deposits are entitled to pass-through insurance. This change was effective December 19, 1992.

Since it is not always clear to prospective benefit plan administrators when an institution is permitted to accept brokered deposits, FDIC is considering ways for depository institutions to inform plan administrators whether the deposits of their plans will be entitled to pass-through insurance coverage.

- Effective December 19, 1993, only the vested interest of an individual will be recognized when the FDIC aggregates that individual's interest in IRAs, self-directed Keogh Plan accounts, "457 Plan" accounts and self-directed defined contribution plan accounts. For accounts comprised of funds from any other type of employee benefit plan, however, the FDIC will continue to recognize both vested and unvested interests for insurance purposes.

- A Bank Investment Contract (BICs) is generally a separately negotiated depository agreement between an employee benefit plan and an insured depository institution, which guarantees a specified rate for all deposits made over a prescribed period. If a BIC permits "benefit responsive" withdrawals or transfers, i.e., permits the employee-beneficiary to direct or transfer funds into or out of the BIC without substantial penalty or adjustment, the deposits made under the BIC are not entitled to deposit insurance coverage. This change is effective December 19, 1993.

Effect on FDIC Operations

The rule changes governing the insurance coverage of benefit plan deposits should have no significant effect on the supervisory activities of the FDIC.

Status

The FDIC has adopted a final regulation implementing the mandated changes. The regulation became effective June 24, 1993, except for certain provisions which are effective December 19, 1993. The final regulation was published in the Federal Register on May 25, 1993.

Contact

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Sources

FIL-40-93 (5-28-93)	Final Rules Affecting Insurance Coverage of Certain Retirement and Other Employee Benefit Plan Accounts (Part 330)
Publication	FDIC booklet entitled "Your Insured Deposit" (1993).