Banking in the Ninth

November 2012

Ninth District Highlights

The Merits of Documentation: From the Viewpoint of the Supervisee

I typically interact with depositories as a supervisor. Documentation and the requests for more documentation often play a central role in those interactions; supervisors typically ask depositories to review current documentation of policies and practices. Changes requested by supervisors often work their way through alterations to current documentation or creation of new documents. These requests may lead bankers at times to wonder if the benefits from documentation have been oversold.

I know the feeling. I often find myself on the other side of the proverbial desk when it comes to documentation. Federal Reserve Banks act on behalf of the Board of Governors of the Federal Reserve System (Board). The Board delegates its supervisory authorities to Reserve Banks. Naturally, the Board wants to ensure that Reserve Banks operate efficiently, effectively and with integrity. Requests from the Board to check current documentation of our policies, procedures, output, etc. and to recommend additional documentation are commonplace.

This experience leads me to conclude that, on balance, documentation of what we are doing and what depositories are doing makes sense; the benefits seem real and important. What specific benefits do I see? Three closely related items come to mind.

Ron Feldman

Getting on the same page. Employees of an organization, particularly a small one, often have the same understanding of how things work even if communication of policy and process is informal. But this is not always the case. Common, informal knowledge can sometimes prove fleeting. We have seen banks suffer when a single loan officer or a single branch did not fully understand expected practices, in part, because what was expected was not written down. Our supervisory efforts have also benefited from moving to more formal communication of what everyone should know already.

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SAFETY and SOUNDNESS UPDATE

Junior Lien Refinancing Wave

Some banks face a potential risk from an upturn in refinancing of junior liens. We discuss this potential risk and identify some risk management practices banks should consider.

Some banks significantly increased home equity lending in the precrisis period. Ten-year, interest-only terms were not uncommon. In the next few years, many of these loans will likely convert to an amortizing loan or require a balloon repayment at maturity. A dramatic payment increase can be a significant problem for troubled borrowers. Moreover, declining real estate values may essentially leave these junior positions unsecured. How should banks manage this potential risk?

Bank management must first consider several key underlying factors about their portfolio and the related risk management response.

- What are the risk characteristics of your junior lien portfolio?
- How should you respond to those risk characteristics?
- What is your strategy for:
  - Maturing junior liens when the first mortgage is delinquent, or

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* Combined loan-to-values (LTV) above the bank's underwriting guidelines, or
* Borrowers experiencing financial challenges?

Federal Reserve examiners have observed some good risk management practices at banks that address these considerations. One such practice is periodically analyzing the risk characteristics of the portfolio and individual loans. Some banks set a review threshold for individual loans where the estimated combined LTV is greater than, say, 80 percent. For these loans, credit reports are pulled; estimated global debt-to-income is calculated; and current credit scores, other debt obligations, credit line utilization and historical delinquency are considered. This standardized analysis is documented much like a risk rating form. This process establishes risk parameters that promote early risk identification and a consistent strategy across the bank. Other banks may periodically refresh credit scores for all junior lien borrowers to begin assessing collection risk. Segmenting the junior lien portfolio by loans with similar risk characteristics also enhances the accuracy of the ALLL methodology.

Examiners have also observed good risk management practices when banks renew junior liens at maturity. One example is underwriting loans as new credit relationships by obtaining new credit applications, analyzing and verifying applicants' incomes, obtaining new appraisals or evaluations, and pulling new credit reports. Conversely, examiners have observed instances where banks have not appropriately reported troubled debt restructurings (TDRs). If a junior lien borrower is experiencing financial difficulties and the bank grants a concession it would not otherwise consider, the loan should be reported as a TDR. Moreover, a practice of granting interest-only extensions to keep loans current that mask repayment problems will be criticized.

Appropriate risk management and a clearly communicated bankwide strategy will allow bank management to identify and effectively respond to risks before the second lien wave arrives. SR letter 12-03 issued in January 2012 provides additional guidance for managing junior lien portfolios.

More information on home equity lending is available in the Consumer Affairs Update, which discusses periodic statement disclosures of home equity lines of credit.

Checking to a standard. All employees and organizations deserve feedback on their performance. Such feedback makes it possible for organizations and their employees to improve. Providing effective feedback requires an understanding of the expectations of the organization beforehand. Writing it down—in the form of polices or procedures, for example—seems the fair way to set an evaluation baseline for employees. The cliché that one must measure to manage seems particularly apt for documentation that reflects concrete and quantitative standards (where appropriate).

Writing as a discipline on thinking. I have fallen prey to the following conceit too many times: I strongly believe I have a good idea about how to improve a process or create something new, only to find that writing down said improvement or new product idea proves me wrong. The very process of writing requires that we confront weaknesses in our thinking that we had heretofore blocked out. This forces me, and I think others as well, to either abandon an inadequately developed proposal or improve an idea. Creating a contingency plan may sound like an exercise in documentation alone. In fact, it can solidify an organization's thinking on how to manage in the face of turmoil.

Of course, not all documentation is created equally. Sometimes it feels like I have to document something just so others can make sure that the document exists. This may not seem particularly beneficial at first blush, even if I understand why the reviewer cannot rely on my word alone. But with the perspective of time and distance—and as I write this down—I conclude that the low-benefit documentation effort is the exception not the rule.

—Ron Feldman
Senior Vice President, SRC

APPLICATIONS FILING TIPS

Federal Reserve staff sometimes identify aspects of sale agreements that would allow buyers of banks to control operations of the target entity before they are allowed to. These features of the sales agreement can slow down the applications process and, if not corrected, could even prevent consummation. This article provides guidance on how to avoid such "prior control concerns."

The prior control concerns arise in our review of sales agreements between the acquiring bank holding company (Buyer) and the selling entity/individual (Seller). The agreements often contain provisions meant to protect the Buyer from actions by the Seller that would adversely affect the value of the target institution. However, these restrictions may raise issues of prior control.

In particular, sale agreements we review frequently include provisions that require the Seller to obtain the Buyer's approval or consent to take an action or conduct a transaction. The following are examples of such provisions:

- Making or committing to a capital expenditure in excess of a given dollar amount;
- Making, renewing or committing to any loan in excess of a given dollar amount;
- Selling or transferring any portion or all of the bank's loan portfolio or investment portfolio; or
- Granting any increase in employee salaries or benefits.

A Buyer can avoid concerns of exercising prior control by ensuring that provisions do not restrict the target entity from conducting normal and ordinary business activities. For example, dollar thresholds contained in restrictive provisions should be large enough to capture only unusual transactions for the target. Provisions that allow the Buyer the right to review the books and records of the Seller or target bank with respect to litigation may also raise a prior control issue. In particular, such access may effectively waive the Seller/target bank's attorney-client privilege. Applicants can avoid this concern by including a clause prohibiting disclosure of attorney-client privileged information to the Buyer prior to consummation.

When restrictive provisions raise prior control issues, we will require the Buyer to address the matter by taking one of the following actions:

- Amending or removing the provision from the agreement;
- Committing not to enforce the provision; or
- Demonstrating that the provision does not restrict the Seller from conducting normal and ordinary business activities and transactions. This may require that the Buyer provide details (such as the number of loans made in a recent period that would have triggered the provision) as to the extent to which the provision has been or is likely to be triggered prior to approval of the proposal.

Questions pertaining to potential prior control issues in sale agreements can be directed to staff of the Applications section.

Contact information is available at http://www.minneapolisfed.org/banking/apps/info/contacts.cfm.

CONSUMER AFFAIRS UPDATE

Home Equity Lines of Credit (HELOC) – Periodic Statements

Recent Federal Reserve consumer examinations have identified cases of fee disclosure errors on HELOC periodic statements. Currently, banks have two options for providing HELOC periodic statement disclosures, which we will discuss. Banks should determine the option used and then ensure appropriate disclosure of fees in the statements. Failure to disclose these fees accurately may result in understated finance charges and potential reimbursement to customers.

Option 1: Non home-secured open-end plan rules. Effective July 1, 2010, HELOC periodic statement disclosures may be provided according to the requirements for non home-secured open-end plans under Regulation Z. Under this option, banks may group fees, including finance charges that are financed, and interest charges separately. In addition, banks do not need to disclose an effective annual percentage rate (APR). Banks that assess fees that would have impacted the effective APR must:

- Group finance charges attributed to periodic interest rates, using the term "interest charge," under the heading *Interest Charged*. The bank must also disclose interest totals for the statement period and calendar year.
- Group other charges imposed as part of the plan under the heading *Fees*, identified by feature or type. The bank must also disclose fee totals for the statement period and calendar year.

Regulation Z provides a model format for reference.

Option 2: Home-secured open-end plan rules.[1] Under the second approach, banks must disclose and itemize finance charges added to the account during the billing cycle, using the term "finance charge." Banks must distinguish between amounts attributed to periodic rates and other finance charge amounts. It is important to ensure that your bank includes financed charges in these disclosures, whether financed initially or during the life of the loan, as follows:

- Start-up fees paid from the first advance, such as points, loan fees or other similar account-opening charges, must be included as part of the finance charge on the first periodic statement; these charges need not be factored into the APR.
- Other finance charges that occur during the life of the loan, such as transaction or advance fees, must also be included in the finance charge on the periodic statement. Banks must include these charges when calculating the effective APR.

Banks that review their HELOC periodic statements to ensure proper disclosure of fees should be less likely to violate requirements.

More information on home equity lending is available in the Safety and Soundness Update, which discusses good risk management practices for refinancing junior liens.

[1] The periodic statement rules for non home-secured open-end plans are included in Regulation Z section 1026.7(b) and for home-secured open-end plans in Regulation Z section 1026.7(a).