FEDERAL RESERVE BANK OF PHILADELPHIA

SRC INSIGHTS

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SVP Observations

by Michael E. Collins

Around the World in Eighty Days by Jules Verne was a classic in its time. Since 1873, however, the world must have shrunk, as information can now travel around the world in mere seconds. No longer are we insulated from the financial, political, and natural events on the other side of the earth. Consequently global crises can develop more quickly than in the past and will require more rapid and coordinated action by authorities in multiple locations.

Technology and a reduction of barriers to trade and capital flows have spurred globalization of nonfinancial and financial markets, altering risks inherent in the banking and payment systems. Trading, clearing, and settlement activities increasingly take place worldwide, linking national payment systems and financial markets. The risks inherent in these linkages were made very clear on October 27, as the weaknesses in the Asian financial markets had a material though brief impact in the United States.

How does the globalization of the economy impact the tri-state area and why should we be concerned? One immediate impact was seen in the stock market. On October 27, the Dow Jones Industrial Average declined 554 points, the largest single day decline in history. All investors in the market, including your employees and your customers, suffered a financial loss (albeit temporary) on that date. Fortunately, the market has rebounded from the initial impact, as the fundamental U.S. economy remained strong.

However, there are other areas where the impact of the weaknesses in the Asian market may be more subtle. To understand these, let's first take a look at what has happened in Asia over the past year.

Before 1997, investors and banks were pouring money into Thailand, expecting its strong economic growth to continue. Flush with money, Thai banks and finance companies lent heavily, some lending against real estate that was grossly overvalued. Others made loans in dollars that would be repaid in Thailand's local currency, the baht. Thailand's economy continued surging until early 1997, when some investors, concerned about apparent excesses in the market, gradually began to reduce their funding. After a series of events, including government intervention, the baht—together with the local currencies of other southeast Asian countries—began to decline and interest rates began to rise. The weakness also spread to Hong Kong, where heavy borrowing and

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Trust Preferred Securities

by Vincent J. Poppa, Supervising Examiner

Challenge: You want to raise capital to fund asset growth, but you don't want to dilute ownership by selling additional shares of stock. What's an expanding bank to do?

Answer: Issue MIPS, QuIPS, TOPrS, or TruPS. All of these are acronyms used to identify a relatively new type of financing called "Trust Preferred Securities" (TPS). In a nutshell, trust preferred securities allow bank holding companies to increase Tier 1 capital without diluting common stockholders' interests. This summary of the elements of trust preferred securities will touch on the "hows" and "whys" of the matter. However, you should consult a financial adviser to obtain more detailed information on whether or not these securities can benefit your organization.

How To Issue TPS

First, the "hows." A bank holding company that wants to take advantage of the benefits of trust preferred securities first forms an affiliated special purpose nonbank subsidiary, generally a trust partnership. The trust then issues the TPS to the general public and subsequently uses the proceeds of the sale to buy a like amount of junior subordinated notes issued by the parent bank holding company. The debentures generally pay interest and principal equal to the dividends and redemption price of the preferred securities. The interest and principal on the debentures are due at the same time as payment of dividends and redemption price on the preferred securities.

The debentures and the preferred stock usually have lives of thirty to fifty years, with mandatory redemption upon the occurrence of certain special events, and optional redemptions, with or without a premium, after a specified period. Under the declaration of trust, the nonbank subsidiary can have no business or operations other than to purchase and hold the company's junior subordinated debentures and to pay the interest income received on the debentures as dividends to the holders of its securities.

Why Issue TPS

Now, the "whys." Trust preferred securities have achieved their current popularity for a number of business reasons, including preferential capital treatment, low cost, and taxation benefits.

Capital. On October 21, 1996, the Federal Reserve Board issued a press release stating that these instruments would be treated as part of Tier 1 capital for bank holding companies provided the following conditions were met:

1. The instrument provides for a minimum five-year consecutive deferral period on distributions to preferred shareholders;

2. The underlying intercompany loan is subordinated to all other debt and has the longest feasible maturity;

3. These securities, together with other cumulative preferred stock issued by a bank holding company, can only constitute 25 percent of the holding company's Tier 1 capital; and

4. Prior Federal Reserve approval is required before any early redemption of preferred securities.

Any TPS in excess of 25 percent of Tier 1 capital can qualify as Tier 2 capital, subject to the existing limitations on Tier 2 capital. Furthermore, Tier 1 capital can be created at the subsidiary bank level by downstreaming the proceeds from the TPS issue to subsidiary banks.

Balance sheet reporting. For accounting purposes, TPS are carried on the consolidated balance sheet of the holding company issuing the underlying subordinated debt as "minority interest in consolidated subsidiaries." The underlying subordinated debentures do not appear on the consolidated balance sheet as they, together with the subsidiary's investment in the subordinated debt, are eliminated as an intercompany transaction. On the parent only financial statements, the subordinated debt sold to the trust is reported as "balances due to nonbank subsidiaries." The holding company must also disclose several items in a footnote, including:

1. the amount of the underlying subordinated debenture and its terms;

2. a statement that the holding company owns all the voting common stock of the special purpose nonbank subsidiary;

3. a statement that the sole asset of the trust subsidiary is the company's subordinated debentures; and

4. the company's guarantee of the liabilities and expenses of the trust subsidiary.

Rating Agencies. The rating agencies have indicated that they will include TPS and other preferred securities issued by a holding company as equity when performing a credit analysis of a company. However, preferred securities will be limited to a maximum of 15 percent of the company's total equity.

Cost. Many equity issues have a total cost of between 10 and 15 percent, including dividends and capital appreciation. Trust preferred securities are often issued at a much lower cost, with interest rates ranging from 150 to 300 basis points over comparable treasury securities. Further, the cost of this money is generally less than alternative sources of funds for acquisitions and other planned expansions.

Taxation. If structured as a trust partnership, the trust and bank holding company are not consolidated for federal income tax purposes. Consequently, the interest paid by the holding company on the debentures is deductible as interest expense for federal income tax purposes. As the dividends paid on the TPS are equal to the interest on the underlying subordinated debenture, there is no residual income flowing through to the parent bank holding company. Consequently, the holding company is raising quasi-equity capital at the cost of tax deductible debt. This preferential tax treatment has been brought to the attention of the Clinton administration, but to-date it has not closed this loophole. In the meantime, new TPS are being structured in various ways to preserve the tax-exempt treatment, should this tax break be eliminated in future years.

Trust preferred securities receive preferential capital treatment, are low cost, and have tax benefits.

Earnings dilution. There is no dilution to the holding company's shareholders since the transaction is reported as debt on the consolidated balance sheet.

Investors' Benefits. Generally, investors in TPS are institutions, although some TPS are issued in smaller denominations for individual investors. Most publicly offered TPS are issued in denominations of $25 or $1,000, with the $1,000 denomination targeted at an institutional investor audience. Several issues of trust preferred securities, particularly those denominated at $25 a share, are listed on a major stock exchange.

From an investor's perspective, the issue has several attractions. It is a long-term (thirty to fifty years), fixed-rate preferred stock instrument whose rating usually tracks the rating of the public debt of the affiliated holding company. There is less risk that the TPS will default on dividends than there is that the affiliated public company will not pay a dividend on its common stock because the funding for the TPS dividends comes from the interest on the subordinated debt.

The Small BHC Challenge

Naturally, there are disadvantages to trust preferred securities. A small community bank holding company usually would want to issue between $3 million and $15 million in TPS, as anything larger than that would represent a significant increase in its equity base. However, issues of this size are generally not large enough to entice institutional investors. A $15 million minimum issue size and the significant legal, accounting, underwriting, and related costs all could inhibit the smaller institution.

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Flood Insurance

by John D. Fields, Field Manager

Flood insurance. Why should we be concerned about it? After all, very little of the property used as collateral for loans in our market area is located along the shoreline, right?

Did you know that more than 25 percent of all claims paid by the National Flood Insurance Program are for policies outside the special flood hazard area? Did you know that every single state had flood insurance claims in the fiscal year 1995 and 1996? Did you know that floods are the most common natural disaster?

Maybe we do need to be concerned after all. First, a little background…

> Did you know that floods are the most common natural disaster?

The National Flood Insurance Program (NFIP) is administered primarily under two statutes: the National Flood Insurance Act of 1968 and the Flood Disaster Protection Act of 1973 (FDPA). The 1968 Act made federally subsidized flood insurance available to owners of improved real estate or mobile homes that are located in special flood hazard areas (SFHA) if the local community participates in the NFIP. The FDPA required federal financial regulatory agencies to adopt regulations to prohibit regulated lending institutions from making, increasing, extending or renewing an uninsured loan that is secured by improved real estate or a mobile home in a SFHA, if the community in which the property is located participates in the NFIP. Finally, Title V the Riegle Community Development and Regulatory Improvement Act of 1994, known as the National Flood Insurance Reform Act comprehensively revised the flood insurance regulations to decrease the financial burden on the federal government, the public, and flood victims.

The NFIP is administered by the Federal Emergency Management Agency (FEMA). Using historical and topographical data, the director of FEMA determines whether a parcel of real estate is located in a flood-hazard zone. FEMA then prepares maps of identified flood-hazard zones. Since FEMA personnel frequently update these maps, financial institutions should periodically review all lending procedures pertaining to the Act, to determine if land that was not previously located in a flood-hazard area has been reclassified.

In July 1997, the Consumer Compliance Task Force of the Federal Financial Institutions Examination Council (FFIEC) issued guidelines on compliance with the various flood insurance statutes and regulations—*Interagency Questions and Answers Regarding Flood Insurance.* This guide consolidates useful information that will enable financial institutions to comply with the provisions of the Act.

One of the highlights of the Q & A includes guidance on the amount of required coverage. Under the statutes, the amount of required flood insurance coverage is the lesser of the principal balance of the loans(s) or the maximum coverage available under the NFIP. For example, assume a loan of $150,000 is secured by five commercial-purpose buildings, three of which are located in a SFHA and in a community participating in the NFIP. The maximum amount of available insurance under the NFIP is $500,000 per building. The total required amount of insurance for the three buildings would be the lesser of $150,000 or the value of the three buildings separately insured. The lender may allocate the required insurance coverage, but each property must be covered by flood insurance.

Following are some frequently asked questions regarding flood insurance:

- *Must a bank obtain flood insurance coverage when the collateral on the loan was taken solely as an abundance of caution?*
  Yes. The important element is the collateral securing the loan, not the purpose of the loan. If the lender

takes a security interest in improved real estate, the regulation applies without regard to the purpose of the loan.

- *Is a home equity loan covered by the Act?* Yes. Regardless of lien priority, if the loan is secured by a building or mobile home and is located in a SFHA, the loan cannot be closed until insurance has been obtained.

- *Is forced placement of flood insurance allowed?* Yes. The act requires a lender to force place insurance if the following circumstances occur:

  - The lender determines at any time during the life of the loan that the property securing the loan is located in a SFHA;

  - The community in which the property is located participates in the NFIP;

  - The flood insurance coverage is inadequate or does not exist; and

  - The borrower fails to purchase the appropriate amount of coverage.

Since the inception of the Act, the lender has been responsible for determining if the subject property is located in a SFHA and, if required, to purchase and maintain flood insurance. Therefore, prudent lenders should periodically review internal procedures for maintaining flood map documentation and monitoring insurance amounts, renewals and force-placed insurance policies. The key to a successful program is to have a system in place that is fully documented and which is accessible by both consumer and commercial lending officers as well as loan operations personnel. Through this mechanism, a system of accountability can be established at each level, minimizing or eliminating loan exceptions and documentation errors pertinent to flood insurance.

Flood maps and related information on the National Flood Insurance Program may be ordered from FEMA by calling 1-800-358-9616. Alternatively, you can access FEMA's web page at *www.fema.gov.**

* This website, which is not affiliated with or authorized by the Federal Reserve System, contains information that may be helpful to you. The Federal Reserve, however, has no control over the information contained therein and cannot guarantee its accuracy.

Trust Preferred Securities

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However, some brokerage firms are attempting to make it easier for smaller issuers of trust preferred securities by creating securities that consist of several issuers' trust preferred issues. Through this mechanism, a brokerage firm would buy the smaller institutions' trust preferred securities with funds raised through a limited market partnership interest. A collection of TPS such as this diversifies the pool and minimizes the risk. In addition, the institutions in the pool could lower the cost of their preferred stock.

Through June 30, 1997, approximately 100 bank holding companies have issued TPS in amounts ranging from $6 million to $2 billion. Although the majority of the issuers were primarily larger institutions with assets greater than $1 billion, a small number of community institutions has issued TPS. Of note, several financial institutions here in the Third District, including community bank holding companies, have already participated in this market.

For more information on trust preferred securities, you may call Vince Poppa at (215) 574-6492 or Cynthia Course at (215) 574-3760. However, if you are seriously considering entering the TPS market, you would be well advised to discuss the matter with your financial advisor very early in the process.

Section 20 Subsidiaries

by Rufus L. Miley, Supervising Examiner

For many years, financial institutions, lobbyists, and Congress have been discussing and sometimes debating the merits of financial modernization. The central issue is if, and to what extent, the barriers between banking, insurance, securities activities, and commerce should be lowered or eliminated. While the debates continue, over the past ten years 43 bank holding companies and foreign banking offices have taken the first step into the future by forming "Section 20" subsidiaries.

> A Section 20 is a subsidiary of a BHC that can underwrite and deal in bank ineligible securities.

A Section 20 subsidiary is a separately capitalized subsidiary of a bank holding company that is authorized to underwrite and deal in bank ineligible securities under Section 20 of the Banking Act of 1933, also known as the Glass-Steagall Act. Section 20 is the section of the Glass-Steagall Act that prohibits member banks from affiliating with any organization that is "engaged principally" in underwriting and distributing securities. This prohibition arose in response to perceived abuses that may have contributed to the 1929 crash of the financial markets and the subsequent collapse of the American banking system.

If a bank is prohibited from affiliating with an organization that is "engaged principally" in underwriting and distributing securities, how can a parent form Section 20 subsidiaries? Historically, banks have been authorized to underwrite, deal, and invest in eligible securities (e.g., U.S. Government and municipal general obligation bonds) and to execute transactions in other securities as agent for customers. However, in order to remain competitive with other global banking organizations, several larger bank holding companies encouraged the Federal Reserve System to expand permissible activities to include the authority to underwrite and deal in bank ineligible securities.

In 1987, several bank holding companies received approval from the Federal Reserve System to underwrite and deal in certain municipal revenue bonds, 1-4 family mortgage-related securities, commercial paper, and consumer receivable-related securities. These are now referred to as "Tier 1" powers. To remain within the constraints of Section 20 of the Glass-Steagall Act, the Federal Reserve limited the revenues that could be earned from underwriting and dealing in bank ineligible securities to 5% of total revenues.

In response to further requests from the banking industry, in 1989 the Federal Reserve System expanded permissible underwriting and dealing activities to include any type of debt or equity securities except mutual funds. These are now referred to as "Tier 2" powers. Again, the limitations applied.

Today, all Section 20 subsidiaries are subject to limitations on the amount of revenue derived from underwriting and dealing in bank ineligible securities. However, this limitation was recently increased to 25% of total revenues.

To minimize the potential for abuses, applicants requesting Section 20 powers were initially required to agree to numerous commitments or firewalls, with a particular focus on insulating affiliated banks from risks arising from securities activities. Recently, most of these formal firewall requirements were eliminated in favor of adherence to operating standards or other existing statutes.

As of November 20, 1997, there were 43 bank holding companies and foreign banking organizations authorized to operate Section 20 subsidiaries. The breakdown of the powers granted is as follows:

	No. of Institutions
Tier 1 powers	13
Tier 1 and corporate debt powers	2
Tier 2 powers	28
Dormant powers	1

Two Section 20 subsidiaries are located in the Third Federal Reserve District. Hopper Soliday & Co., Inc. (a subsidiary of First Maryland Bancorp) has Tier 2 powers and is located in Lancaster, PA. CoreStates Securities Corp (a subsidiary of CoreStates Financial Corp) has Tier 1 powers.

Tier 2 subsidiary applicants, which by definition are involved in a wider array of activities, are generally subject to a review of the managerial and operational infrastructure prior to receiving approval. This review focuses on the adequacy of management, internal controls and risk management systems, computer and accounting systems, internal audit, and the results of examinations conducted by self-regulatory organizations. This review is conducted on-site, and an organization must have an adequate infrastructure in place (not contemplated) for approval.

While Tier 1 subsidiaries are not subject to an on-site review of the managerial and operational infrastructure *prior* to approval, the application must include a representation of the adequacy of pertinent elements. An on-site review of the subsidiary is required within 3 to 6 months of commencement of activities.

Since Section 20 subsidiaries are registered broker/dealers, they are members of the National Association of Securities Dealers (NASD). In addition to being supervised by the Federal Reserve System, Section 20 subsidiaries are also supervised by the NASD. The NASD enforces the Securities and Exchange Commission's minimum capital requirements for the subsidiaries and is responsible for assuring compliance with the various applicable securities laws. Consequently, Section 20 subsidiaries must file monthly Focus reports, which are similar to bank call reports, with the NASD.

All Section 20 subsidiaries are subject to an annual inspection by Federal Reserve System examiners. The inspection does not duplicate the reviews conducted by the Securities and Exchange Commission and/or the NASD. Rather, it focuses on the impact that the Section 20 subsidiary has on the bank holding company or foreign banking organization. Consistent with the current focus of all examinations and inspections, the ability of the Section 20 subsidiary's management to manage risk is an important aspect of the inspection, as are compliance with the Board's revenue test and operating standards.

If you are interested in learning more about Section 20 subsidiaries, please contact Rufus Miley at (215) 574-4129, John Mendell at (215) 574-4139, or John Deibel at (215) 574-4141. ■

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investments in real estate had similarly fueled fast growth. In late 1997, the South Korean won devalued due to an increasing level of bankruptcies and defaults. The weaknesses are also moving into Japan, as Japan experienced its biggest-ever corporate failure with the collapse of Yamaichi Securities in late November. Several banks have also failed, prompting discussions of the use of public funds to allay depositor's fears.

Overvalued currencies in many of these countries exposed both the weak banking systems and the risks inherent in heavy government involvement in financial markets. For example, the South Korean government suspended the operations of most ailing South Korean financial institutions and threatened to close them pending the bailout of the country's economy by the IMF. More recently, the Central Bank became majority owner of two banking organizations in Korea through a $2 billion capital infusion, calling into question the future of some U.S. branch or agency operations.

Generally, economists believe that the overall U.S. economy will weather the Asian turmoil in good shape. However, certain local and regional economies in the United States may feel the impact of reduced exports to Asian countries as the recent Asian currency devaluations make U.S. goods more expensive. According to Standard & Poors, the average U.S. state has 2.4% of its gross state product going to Asia. Much of these exports are concentrated on the West Coast; fortunately, the states in our tri-state area are below this average. However, there may be longer-term effects on corporate earnings of firms with extensive export activities, as well as continued trade imbalances in the U.S.

One beneficial impact of the Asian weaknesses is the timely reminder of the potential consequences of lending exuberance. As Chairman Greenspan has noted, some of the problems in Japan and the rest of Asia may have been driven by excess liquidity, or too much money chasing investment opportunities. Many of us saw the consequences of excess liquidity firsthand in the late 1980s and early 1990s when banking institutions in the northeast suffered record lending losses. However, many lenders have only experienced the recovery period of the past seven years. The turmoil in Asia is a vivid reminder that asset quality can never be ignored, even during economic expansions, and that the business cycle has not and cannot be revoked. ■

NEXT ISSUE

Aquiring ORE

Protecting Your Operations From Trading Fraud

Regulatory Accounting Update

Editor.................Cynthia L. Course

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