Being Competitive in a "Reregulated" Banking Environment: The Case of Commercial Lending Activities of Banking Institutions†

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I. Introduction

Banking institutions1 are subject to a "dual" regulatory system of state and federal regulations, with the federal system fragmented among various regulators.2 This multiplicity

† The genesis of this article stems from a paper presented at an Oklahoma City University School of Law conference entitled "Commercial Lending and Equipment Leasing." A version of this article will appear as Chapter 4 in an upcoming treatise, Commercial Lending Guide, to be published by the Matthew Bender Co. in fall 1987. Unless otherwise indicated, the state of the law reflected herein is as of September 1, 1986.

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1. Unless otherwise indicated, the term "banking institutions" includes commercial banks, thrift institutions (i.e., savings and loan associations) and bank or S&L holding company units, with particular emphasis on federally regulated institutions.

and pyramid of regulation complicates an institution's flexibility and ability to conduct commercial lending activities\(^3\) and alternative commercial financing services\(^4\) in an increasingly competitive marketplace of financial intermediaries (many of which are largely unregulated or, at least, subject to less regulation and fewer regulators).\(^5\) This result is true even in a period of “deregulation”\(^6\) which seemingly is enhancing the competitive position of banking institutions through expanded lending and investment powers, inasmuch as these expanded powers have brought with them “reregulation”\(^7\) and revamped supervisory and enforcement procedures\(^8\) of the various regulators of these institutions. The primary objective of this article is to examine the scope and nature of the regulatory framework for banking institutions regarding their commercial lending activities, in the context of the business need for marketplace flexibility and the public need to “reregulate” banking institutions to ensure the “safety and soundness” of these institutions and of the banking system as a whole.

II. OVERVIEW OF THE PRESENT REGULATORY ENVIRONMENT

To appreciate the full implications of the regulatory framework for commercial lending activities, one should first have an understanding of the fragmented system of regulation for banking institutions, the legal dimensions of the bank deregulation, and the statutory scope of the lending and investment powers for such institutions.

3. On commercial lending practices by banking institutions, see, e.g., D. Hayes, Bank Lending Policies (2d ed. 1977); G. Hempel, A Coleman & D. Simonson, Bank Management, Part IV (2d ed. 1986); Commercial Loan Documentation Guide, Ch. 1 (J. Norton ed. to be published fall 1987) [hereinafter Norton-CLG].

4. In an effort to reduce their risk exposure, banking institutions (particularly the larger institutions) are shifting their emphasis from traditional commercial lending activities to more fee-generating and investment banking-type services. See infra text accompanying notes 443-56.


8. See infra text accompanying notes 457-58.
A. The Regulatory Scheme

In order to determine the laws applicable to a specific banking institution or "banking" function, it is important to ascertain under which law the institution is chartered and the responsible regulators:

1. Commercial Banks. The regulation of commercial banks is as follows:

   National banks are chartered and supervised by the Comptroller of the Currency (Comptroller), are members of the Federal Reserve System (FRS) subject to Federal Reserve Board of Governors (FRB) regulations and are insured by, and subject to the regulation of, the Federal Deposit Insurance Corporation (FDIC).

   State chartered banks are regulated by the relevant state bank authority and may choose to become members of the FRS. If a state bank becomes a member of the FRS, it is insured by the FDIC.

   State banks may choose to be insured by the FDIC without becoming members of the FRS.

   Unless otherwise required by state law, which is the case in most states, state banks may choose to operate independently from the FRS and the FDIC.

2. Savings and Loan Associations. The regulation of savings and loan associations (S&Ls) is as follows:

   Federal S&Ls are chartered and supervised by the Federal Home Loan Bank Board (FHLBB), are members of the Federal Savings and Loan System (FSLS) and are insured by, and subject to the regulations of, the Federal Savings and Loan Insurance Corporation (FSLIC).

   State chartered S&Ls are regulated by the relevant state banking authority or savings and loan department and may choose to become members of the FSLS. In order to secure membership in the FSLS, S&Ls must obtain FSLIC insurance.

   State chartered S&Ls may choose to be insured by the FSLIC without becoming a member of the FSLS.

   A state chartered S&L may choose not to be insured by the FSLIC or to be a member of the FSLS.9

B. The Deregulation Scheme

When one considers the legislative and regulatory environment for banking institutions and their lending functions, a helpful approach is to try to fit these functions into the overall context of the "deregulation scheme." During the past decade there is probably no industry in the United States that has experienced the accelerated structural changes as has the banking industry. These changes have been brought about by rapid and continuing technological changes, the development of an increasingly sophisticated and interchangeable customer base that requires an ongoing increase of new financial services, growing intra-industry competition between the traditionally segmented commercial banking industry and the thrift institution industry, compressing competition from non-bank financial institutions in the search for new customer base in the delivery of financial services, and at least until recently, unprecedented levels in volitility of interest rates that in the thrift industry created a significant disintermediation that compelled very substantial structural changes in the industry and that generated very substantial banking legislation.10

In terms of the functional aspects of the deregulation scheme, one is talking about (i) deregulation of the asset side of a banking institution's balance sheet (i.e., an expansion of the business opportunities and products services that can be offered), (ii) deregulation of the liabilities-side of a banks balance sheet (i.e., expansion of depository sources, primarily through the offering of new depository vehicles and through elimination of traditional restrictions on the pricing of deposits) and (iii) deregulation of geographic restrictions on the

intrastate and interstate activities of banking institutions. These aspects of deregulation are important to banks and their commercial lending functions because they touch upon the scope of such institutions’ lending powers, funding availability and geographic marketing of such lending and related services.

Also, centrally related to this whole deregulation scheme is the present inquiry concerning rationalization of the multiplicity of bank regulators, a matter without the scope of this paper and recently addressed in the Bush Task Force Report. Another central issue, the pressures for which may be at times all too latent yet pervasive, yet at times the manifestations of which may be all too notorious (a la Penn Square, Continental Illinois and United American Bank), is the interrelationship of deregulation to traditional banking objectives, particularly sacred of which is the notion and legal requirement of “safety and soundness.” The bank regulators are using “safety and soundness” concerns to revamp bank examination procedures, to revise loan classifications guidelines, to enhance civil and criminal actions against banking institutions and bank management for management, to reexamine the deposit insurance scheme, and to overhaul capital adequacy rules and guidelines. In summary, an understanding of the functions of a banking institution requires comprehension of the bank deregulation scheme and the internal and external competitive forces faced by various types of banking institutions both federal and state.

11. See generally Department of the Treasury, Geographic Restrictions on Commercial Banking in the United States (1981); supra note 5.


14. See, e.g., remarks by Senior Vice President (Supervision) for Federal Reserve District Bank of Dallas, Mr. George C. Cochran, Developments in Safety and Soundness Concerns of Bank Regulators, Second Annual Short Course on Law of Banking Institutions (Dec. 2-6, 1985, Southern Methodist University School of Law).
1. The Federal Environment

Federal bank regulation has traditionally restricted competition among banking institutions.\(^{16}\) This was accomplished by the performance of different functions by different institutions. Bank regulators also controlled depository interest rates and, until recently, this control was exercised in a protective manner.\(^{16}\) In addition, the Federal Deposit Insurance Act was enacted to promote "safe and sound" banking practices and to protect bank deposits through deposit insurance.\(^{17}\) Further, Congress geographically divided the banking industry pursuant to the McFadden Act\(^{18}\) and restricted interstate banking by passage of the Douglas Amendment to the Bank Holding Company Act (BHCA).\(^{19}\)

The restrictions on competition among banking institutions are gradually being reduced. For example, the enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980 (1980 Omnibus Banking Act) fosters competition among banking institutions and (some may argue) reshapes the traditional banking objectives of "safety and soundness."\(^{20}\) This act fosters competition by granting significant powers (including broadened lending powers), in addition to those then presently exercised, to S&Ls and other thrift institutions, by phasing out interest rate ceilings and differentials on deposits and by preempting many of the state usury laws. Most recently, the restrictions on competition among banking institutions have been reduced further by the passage of the Garn-St Germain Depository Institutions Act

\(^{15}\) Compare Huck, What is the Banking Business? 21 Bus. Law. 537 (the banking business consists of fundamental or incidental services); and Schweitzer, Banks and Banking — A Review of a Definition, 94 Banking L.J. 6 (1977) (banking functions should be defined by rational economic criteria rather than historical description).

\(^{16}\) E.g., Banking Act of 1933, ch. 89, § 10, 48 Stat. 181, 182 (1933) (amended 1982).


of 1982 (the 1982 Banking Act).\textsuperscript{21} Significant pieces of additional bank legislation are pending before this Congress. In sum, competition is being enhanced on the asset side and the liability side of the balance sheet of all banking institutions.

In addition, the business opportunities of banking institutions are expanding through liberal interpretation of their "incidental powers" authority\textsuperscript{22} and through the use of related, "non bank" corporate entities, such as service corporations, generally within a holding company unit.\textsuperscript{23}

Bank regulation also has separated banking institutions from non bank financial intermediaries. For example, the Glass-Steagall Act separates commercial banking from investment banking.\textsuperscript{24} Nonbank financial intermediaries have been taking advantage of this limitation on bank activities by offering an increasing array of financial and financing services, and thereby competing for traditional bank customers (including corporate customers of banks). For banking institutions, Glass-Steagall concerns are particularly important with respect to the development of alternative financial services in securities-related areas that may be offered to their business clients.\textsuperscript{25}

2. The Competitive Position of State Banking Institutions

Although the emphasis of this article is on federally chartered banking institutions, state banking institutions are a significant numerical factor in the United States banking system.\textsuperscript{26} Even certain major commercial banks (e.g., Bankers


\textsuperscript{23} See \textit{infra} text accompanying notes 453-56.


\textsuperscript{25} See \textit{infra} text accompanying notes 453-56.

\textsuperscript{26} On state banking laws generally, see Banks: Organization and Function, 1 Banking Law chs. 2-5 (MB) (1985 & Supp.).
Trust and Manufacturers Hanover) remain state chartered institutions. Also, with deregulation many state banking systems have been most aggressive in competing for bank charters and related business. For example, the State of Delaware recently enacted a banking law that (i) expands bank powers; (ii) confers extensive credit powers, including the elimination of maximum usury rates and the retroactive application of certain changes in a credit account agreement; (iii) reduces bank taxes and (iv) authorizes out-of-state banking laws to attract domestic and interstate financial interests. Other states, such as Maryland and South Dakota, also are liberalizing their state banking laws. In certain instances, state laws (e.g., in a Glass-Steagall context) may permit broader powers than federal laws and regulations. Accordingly, in assessing a banking institution's competitive position and the applicable statutory and regulatory framework, one must be aware of the expanding business opportunities of various state banking institutions.

Traditionally, state banks derive their powers from state banking laws and state bank charters. Express statutory powers include the power to (i) contract with bank customers, (ii) borrow money, (iii) act as agents for bank customers, (iv) issue drafts, (v) make loans, (vi) negotiate and endorse note and bills of exchange, (vii) issue guarantees in limited circumstances, (viii) issue letters of credit, (ix) hold and acquire real estate in limited circumstances and (x) buy and sell stock in limited circumstances. In addition, state banks have those powers that can be fairly implied from their express powers or are incidental to their express powers. Also, many states have "wildcard" statutes that permit state banks to have owners equivalent to those of a national bank.

30. For example, non-Federal Reserve System state banks and state S&Ls are apparently outside the statutory embrace of the Glass-Steagall Act, with any prohibitions in securities related activities resting with applicable state laws and regulations.
31. See generally 1 Banking Law, supra note 26, at § 4.04.
32. Id. at § 4.03[10].
C. The Statutory Bases for Lending and Investment Powers

All activities of a banking institution must have express statutory or regulatory bases or be deemed to be an activity or power incidental to or implied from an express power.33

1. National Banks

National banks, the predominant commercial lender among banking institutions,34 may enter into any type of lending relationship provided that the relationship does not exceed lending limits based upon the bank's capital accounts. These banks derive their lending powers primarily from the National Banking Act.35 The banks are empowered, subject to applicable lending limits, to discount and to negotiate promissory notes, drafts, bills and exchanges and other evidences of indebtedness and to lend money on personal security.36 The Federal Reserve Act authorizes the Comptroller to set the conditions and limitations regarding loans secured by real estate,37 a subject without the scope of this text. The relevant Comptroller regulations on lending activities are contained in Title 12 of the Code of Federal Regulations.38

2. Savings and Loan Associations

Federally chartered S&Ls derive their lending powers from the Home Owners' Loan Act of 1933, as amended (HOLA).39 Historically, these institutions were restricted to lending funds on the security of their shares or on the security of first lien mortgages within the limited geographic area of their home office.40 Through numerous amendments over the

33. Id. at § 4.01.
34. Bush Report, supra note 19, at 20. In terms of assets, national banks comprise 60% of total bank assets, although numerically accounting for only 33% of the approximately 14,000 commercial banks in the United States.
35. See National Banks, 2 Banking Law § 28.02 (MB) (1985 & Supp.).
37. See 2 Banking Law, supra note 35, at § 28.02.
40. Id. at 48 Stat. 132, § 5(c).
years (particularly Title IV of the 1980 Omnibus Banking Act and Title III of the 1982 Banking Act), the lending powers of federal S&Ls have been substantially expanded. The relevant FHLBB regulations on lending activities of S&Ls are contained in Title 12 of the Code of Federal Regulations.

With deregulation, the commercial and other lending powers of S&Ls have significantly expanded. However, in contrast to the lending powers of national banks, the lending activities of federal S&Ls are limited by lending limitations in several loan categories. To summarize, a federal S&L currently has statutory authority to grant: loans on the security of its transaction accounts; loans on the security of liens on real property (loans secured by nonresidential real property are subject to a 40% aggregate loan limitation); loans for home improvement and loans for manufactured homes; certain federally insured loans to finance the purchase of real estate; loans to financial institutions subject to federal examination or supervision or to federally registered brokers or dealers, secured by loans, obligations or investments that the S&L has statutory power to invest in directly; secured or unsecured consumer loans (subject to a 30% aggregate limitation); educational loans (subject to a 5% aggregate limitation); nonconforming real estate loans for primarily residential or farm purposes (subject to a 5% aggregate limitation); loans to business development credit corporations (limited in the aggregate to the lesser of 1% of the S&L’s assets or $250,000 and subject to other requirements); loans secured by mortgages as to which the S&L has the benefit of

42. See 12 C.F.R. § 541-556.7 (1986).
45. Section 322 of the 1982 Banking Act, deleted all loan-to-value ratios.
49. Id. at § 1464(c)(2)(B); 12 C.F.R. § 545.50.
50. Id. at § 1464(c)(3)(A).
51. Id. at § 1464(c)(4)(A).
federal insurance; federal insurance; loans for commercial, corporate, business or agricultural purposes (subject to a 10% aggregate limitation). A federal S&L now also is authorized, subject to regulations of the FHLBB, to issue credit cards and to otherwise engage in credit card operations.

Loans to a single borrower by an S&L are limited to the amount that a national bank with the same capital and surplus can make. Federal S&Ls have the authority to lease or sell tangible personal property, including, without limitation, vehicles, manufactured homes, machinery, equipment and furniture.

However, as will be discussed subsequently, the lending powers of banking institutions bring new and different risks and concerns for bank regulators in such areas as classification of loans and determination of adequate loan loss reserves, capital adequacy, insider transactions and international lending.

III. LIMITATIONS ON FUND AVAILABILITY

Limitations on funds available for loans made by banking institutions may include borrowing limitations, reserve requirements and liquidity requirements. Certain credit allocation, capital adequacy, asset classification and allowance for loan loss requirements may also affect the availability of funds for lending purposes and the overall costs of lending.

A. Aggregate Borrowing Limitations

Prior to the enactment of the 1982 Banking Act, the National Bank Act (NBA) set forth an overall limitation on the amount of indebtedness that a national bank may incur or for

52. Id. at § 1464(c)(4)(C); 12 C.F.R. § 545.38.
55. See infra notes 244-51 and accompanying text.
57. See infra notes 151-56 and accompanying text.
58. See infra notes 95-150 and accompanying text.
59. See infra notes 252-303 and accompanying text.
60. See infra notes 304-40 and accompanying text.
61. See infra notes 401-26 and accompanying text.
which it may in any way be liable. The NBA had established an aggregate limit not to exceed the bank’s capital stock, plus 50% of the amount of its unimpaired surplus fund. However, the 1982 Banking Act repealed this aggregate borrowing limitation. Yet such borrowings remain subject to the overall (and often elusive) statutory and regulatory requirement to maintain “safe and sound” banking practices. Federal S&Ls are not subject to an aggregate borrowing limitation but are subject to the extent that they are required to maintain “safe and sound” practices.

B. FRB Reserve Requirements

All “depository institutions” are required to maintain legal reserves pursuant to statute and to FRB Regulation D. This revised regulation D resulted from requirements of the Monetary Control Act of 1980 (Title I of the 1980 Omnibus Banking Act). These reserve requirements directly affect an institution’s overall cost of funds and, thus, the ultimate pricing of a loan arrangement.

For purposes of regulation D, a depository institution includes:

- any federally insured commercial or savings bank;
- any such bank eligible to become insured by the FDIC;
- any mutual or stock savings bank;
- any S&L that is a member of the FHLBB;
- any S&L eligible for FSLIC insurance;
- any credit union insured with the National Credit Union Administration;
- any credit union eligible for such insurance;

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64. See, e.g., Groos Nat'l Bank v. Comptroller of the Currency, 573 F.2d 889, 897 (5th Cir. 1978).
68. See, e.g., Gass, Loan Pricing, comprising ch. 5 in NORTON-CLG, supra note 3.
U.S. branches or agencies of foreign banks with total world wide assets in excess of $1 billion; and any “Edge Act” and “Agreement” corporation. 69

Regulation D provides three categories of deposits for purposes of reserve requirements:

(i) transaction accounts — demand deposits (i.e., deposits that can be legally withdrawn immediately and without notice), negotiable order of withdrawal (NOW) accounts, savings accounts, savings accounts subject to Automatic Transfer Services (ATS), share draft accounts, accounts subject to preauthorized telephone transfer or withdrawal and all accounts that permit the account holder to make third party payments using automated teller machines (ATMs) or remote service units (RSUs). Transaction account computations are “net,” that is, total of such accounts less certain permitted deductions; 70

(ii) nonpersonal time deposits — time deposits or accounts that are transferable, time deposits or accounts representing funds deposited to the credit of, and which any beneficial interest is held by, a depositor that is not a natural person (whether or not transferable); 71 and

(iii) Eurodollar liabilities — net borrowings from related foreign offices, loans to United States residents made by overseas offices of depository institutions in the United States, sales of assets by these institutions to their overseas offices and proceeds of sales to foreign branches of all assets. 72

Regulation D provides the following reserve requirements to the above categories of deposits:

(a) transactions accounts — 3% of first $36.7 million or less; $1,101,000 plus 12% on excess above $36.7 million;

(b) nonpersonal time deposits, having an original maturity of less than 1 1/2 years — 3%;

(c) nonpersonal time deposits, having an original maturity over 1 1/2 years — 0%; and

69. 12 C.F.R. §§ 204.1(c)(2), (3) and 204.2(m)(1) (1986).
70. Id. at § 204.2(e). Transaction account computations are “net,” that is, total of such accounts less certain permitted deductions. See id. at § 204.2(j).
71. Id. at § 204.2(f). Commercial paper and due bills may be reservable deposits in certain circumstances. See id. at § 204.2(a)(1).
72. Id. at § 204.2(h).
(d) Eurocurrency liabilities — 3%.\textsuperscript{73}

reservable liabilities, including deposits, up to $2,870,000 held by any depository institution are not subject to reserve requirements.\textsuperscript{74} Regulation D reserve requirements may be satisfied by vault cash (except gold or silver) and balances held directly or on a pass-through basis with a Federal Reserve District Bank.\textsuperscript{75}

Commencing February 2, 1984, reserve computations (for depository institutions with total deposits of $15 million or more, edge corporations and United States branches and agencies of foreign banks) are to be made on the basis of a contemporaneous accounting system. This system, which may result in significant new costs to depository institutions, requires such institutions to maintain prescribed reserves on a daily average basis for a 14-day maintenance period and to make reserve adjustments within two days of the prescribed computation date, rather than the old system of permitting a two-week lag.\textsuperscript{76}

Effective November 4, 1982, the FHLBB amended its reserve requirements for FSLIC insured institutions to include (for statutory reserve, as well as for net worth tests) a new item called "appraised equity capital." This term is essentially the mathematical difference between the net book value and the appraised market value of office, land, building and improvements (including leasehold improvements) owned by the insured institution or any of its subsidiaries or, in some instances, the deferred profit from a sale with leaseback of formerly owned office property.\textsuperscript{77} FHLBB examiners have been advised that, effective March 31, 1983, S&L reserve requirements on nonpersonal time deposits were modified to conform to FRB regulation D requirements.\textsuperscript{78} Reserve reporting requirements by depository institutions vary according to levels

\textsuperscript{73} Id. at § 204.9(a), as amended by FRS, Reserve Requirements of Depository Institutions; Reserve Requirement Ratios, 51 Fed. Reg. 43,175 (1986).

\textsuperscript{74} See § 411 of the 1982 Banking Act, modified by 12 C.F.R. § 204.9(a)(2).

\textsuperscript{75} 12 C.F.R. § 204.3(b).

\textsuperscript{76} Id. at § 204.3.


of reservable liabilities and deposits. It is clear that state chartered non FRS member banks are subject to FRB reserve requirements.\textsuperscript{79}

C. Liquidity Requirements

Regulatory concern for bank liquidity is primarily addressed through the bank examination process.\textsuperscript{80}

D. Credit Allocation and the Community Reinvestment Act (CRA)

The legislative history of the CRA\textsuperscript{81} demonstrates that this legislation was directed against the practice of "redlining," that is, the use of funds deposited by residents in neighborhood institutions for purposes that would not benefit the depositors or the neighborhoods. In effect, this legislation directs itself to credit allocation, which in turn may impact on the availability of funds for lending purposes.\textsuperscript{82}

The primary purpose of the CRA is to encourage financial institutions to meet the credit needs of the local communities they serve, consistent with the safe and sound operation of the institution. This purpose is achieved through examination of these institutions by the appropriate federal financial supervisory agency.\textsuperscript{83}

The CRA applies to all "regulated financial institutions" (i.e., an institution whose deposits are insured by the FDIC or FSLIC).\textsuperscript{84} The CRA does not establish specific requirements for bank performance but seeks to use the bank's examination process as a device for fostering acceptable "standards" of performance. The standard for assessing the performance of

\textsuperscript{79} First Bank & Trust Co. v. FRB, 605 F. Supp. 555 (E.D. Ky. 1984).
\textsuperscript{80} See, e.g., infra notes 157-59 and accompanying text.
\textsuperscript{83} 12 U.S.C. § 2901(b).
\textsuperscript{84} Id. at § 2902(2).
each financial institution is subjective and is whether each institution serves the convenience and needs of the community in which it is chartered to do business.\textsuperscript{85}

The CRA does not establish a new framework for bank regulation or examination but is superimposed upon, and accordingly is limited by, the existing federal regulatory structures. Thus, the regulatory authorities that implement the CRA are as follows: (i) the Comptroller supervises national bank; (ii) the FRB supervises state-chartered banks that are members of the FRS and supervises bank holding companies; (iii) the FDIC supervises state-chartered banks and savings banks that are not members of the FRS, the deposits of which are insured by the FDIC; and (iv) the FHLBB supervises institutions with deposits insured by the FSLIC and supervises S\&L holding companies.\textsuperscript{86}

The purpose of the CRA examination is two-fold: the continuing assessment and monitoring of a banking institution's record of meeting the credit needs of its entire community, including low and moderate income neighborhoods, consistent with the "safe and sound" operations of such institution; and the consideration of such record of performance when evaluating an "application" by such institution.\textsuperscript{87}

The term "application for a deposit facility" by a national bank, would include, for example, an application for a charter for a national bank, deposit insurance in connection with a newly chartered institution, the establishment of a domestic branch, the relocation of a home or branch office and mergers or acquisitions.\textsuperscript{88}

The CRA provides that the appropriate federal financial supervisory agency has a duty to carry out the purposes of the

\textsuperscript{85} Id. at §§ 2901(a), (b) & 2903.

\textsuperscript{86} Id. at § 2901(a).

\textsuperscript{87} See id. at § 2901(b); see also Givens, The "Antiredlining" Issue: Can Banks be Forced to Lend?, 95 BANKING L.J. 515 (1978); Healey, A Banker's Guide to the Community Reinvestment Act, 96 BANKING L.J. 705 (1979); The Community Reinvestment Act Regulations: Another Attempt to Control Redlining, 28 CATH. UNIV. L. REV. 635 (1979).

\textsuperscript{88} 12 U.S.C. § 2902(3).
CRA. The respective federal regulations are substantively parallel to each other. These regulations are illustrated by the requirement of the Comptroller that a national bank:

prepare and annually review a delineation of the loan community or communities that comprise the entire lending territory of a bank (as portrayed on a map or maps), without excluding low and moderate income neighborhoods. A national bank is permitted to use its "effective lending territory," defined as that area or areas around each office or group of offices where it makes "a substantial portion of its loans," and all areas equally distant from its offices as those areas. The reasonableness of this delineation will be reviewed by the national bank examiners;
adopt a Community Reinvestment Act Statement (CRA Statement) for each delineated community;
post in the public lobby at each of its offices (other than off-premise electronic deposit facilities) a public notice (CRA Notice) in the form prescribed by the CRA.

These are the only express requirements of specific action to be taken by a national bank or a federal S&L.

A national bank is required to maintain records for public inspection, consisting of written comments received from the public within the past two years that are specifically related to any CRA Statement or to the bank's performance, any responses to the comments that the bank wishes to make and any CRA Statements in effect during the past two years. The CRA Statement must be reviewed annually by the bank's board of directors.

The various CRA regulations do not provide specific guidelines for assessing the performance of banking institutions. Performance is assessed within the context of (i) serving the "convenience and needs" of the communities being served.

93. Id. at § 25.4(d).
(which is to include the needs for credit services as well as deposit services), consistent with (ii) the "safe and sound" operations of the banking institution.\textsuperscript{94}

While the CRA is not of direct concern in a commercial lending transaction, this legislation should be of direct concern to management of a banking institution in determining the institution's overall lending policies and in dealing with the regulators in the examination and application processes. Moreover, CRA compliance serves as a very real lever for the regulators in their institutional examinations and in the application processes, a reality that has become more apparent in recent regulatory informal practices.

E. Capital Adequacy Requirements

In November 1983, Congress enacted the International Lending Supervisory Act of 1983,\textsuperscript{95} which directed the federal banking agencies, that is, the Comptroller, the FRB and the FDIC to achieve and maintain adequate levels of capital by establishing minimum levels of capital for banking institutions. Prior to the enactment of this statute, the agencies had adopted capitalization policies under the authority of their regulatory powers;\textsuperscript{96} however, the enforceability of such policies had been challenged.\textsuperscript{97} As discussed below, the banking agencies promulgated uniform minimum capital levels for all federally supervised banking organizations, including FDIC insured banks,\textsuperscript{98} national banks,\textsuperscript{99} Federal Reserve Board member banks\textsuperscript{100} and bank holding companies.\textsuperscript{101} While these


\textsuperscript{97} First Nat'l Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 678 (5th Cir. 1983).

\textsuperscript{98} See infra notes 106-13 and accompanying text.

\textsuperscript{99} See infra notes 114-23 and accompanying text.

\textsuperscript{100} See infra notes 124-29 and accompanying text.

\textsuperscript{101} Id.
capital adequacy requirements do not directly increase the cost of funds, they do increase the overall costs for an institution to conduct business and do limit fund availability. In fact, if the new risk-based capital proposals are enacted (which appears most likely), they may specifically affect lending practices and costs.

The regulations set forth the minimum acceptance ratio of total capital to adjusted total assets at 6% and the minimum ratio of primary capital to adjusted total assets at 5 1/2%. The regulations increased the minimum primary and total capital levels for larger regional and multinational banking institutions and eliminated the disparate minimum capital levels for large and small banking institutions. In summary, the uniform ratios now apply to banking institutions of all sizes.

Notwithstanding these overall, more stringent capital adequacy requirements, the FRB, FDIC and Comptroller have recently issued policy statements that would permit otherwise healthy banks with loans concentrated in the energy and agricultural areas to operate under more lenient capital adequacy rules and rules for accounting for restructured loans.

102. See Norton-CLG supra note 3, ch. 5.
103. See infra notes 142-50 and accompanying text.
105. In the spring of 1986 the federal banking agencies adopted a capital forbearance plan for agriculture and energy banks. Qualified banks, banks with 25% of their loans in agricultural or oil and gas loans, may be permitted to maintain their capital at 4% rather than the previously required 6%. The other condition for qualification for capital forbearance is that the compromised condition of a bank must be the result of difficulties in the agriculture or energy business and not bank mismanagement.

Qualified banks submit an application to the appropriate federal banking agency. The application includes: (i) proof of eligibility and (ii) a business plan that addresses: (a) dividend levels, (b) compensation plans, (c) payments for goods and services to bank affiliates and (d) restored capital by January 1, 1993. Periodic reports on the capital forbearance plan will be required by the granting agency.

The capital forbearance program may impact differently on banks. For example, the lending limit in state banks may decrease under a forbearance plan. In contrast, the lending limit regulation for qualified national banks has been temporarily amended. The amendment substitutes an increased general lending limit to 20% of total capital. The new limit does not increase a bank's lending limit above what it would have been if the bank had not experienced agriculture and energy losses. The temporary amendment expires on January 1, 1993. OCC, National Bank's Lending
1. Federal Deposit Insurance Corporation

Under this regulation all FDIC insured state banks must maintain a ratio of total capital to total assets of at least 6% and a ratio of primary capital to total assets of at least 5½%. If a bank is not deemed to be fundamentally sound and well-managed, then higher ratios may be required. Primary capital is defined to include:

Common stock, perpetual preferred stock, capital surplus . . . undivided profits, capital reserves, mandatory convertible debt (to the extent of 20 percent of primary capital exclusive of such debt), minority interests in consolidated subsidiaries, net worth certificates . . . and the allowance for loan and lease losses and minus intangible assets other than mortgage [sic] servicing rights and assets classified loss.

Secondary capital includes mandatory convertible debt not included in primary capital, limited life preferred stock and subordinated notes and debentures, up to 50% of primary capital. The sum of primary and secondary capital is total capital.

Banks that do not comply with the requirements are subject to several sanctions. Applications will not be approved unless the bank is under an acceptable plan to increase its capital. A bank with less than the required capital is deemed to be engaging in an unsafe or unsound practice.

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107. 12 C.F.R. § 325.3(a) (1986).

108. Id. at § 325.2(h).

109. Id. at § 325.2(i).

110. Id.

111. Id. at § 325.3(c)(2), (3), (d)(2).
Reregulated Banking Environment

unless it is complying with an acceptable plan to increase its capital, and such banks are subject to the issuance of directives. A bank with less than a 3% primary capital ratio is deemed to be operating in an unsafe and unsound condition, unless it is complying with an agreed-upon plan to increase its capital. A bank with a ratio equal to or greater than 3% may be operating in an unsafe or unsound condition.

2. Comptroller of the Currency

The minimum capital ratios are 6% for total capital and 5 1/2% for primary capital for well-managed banks. The Comptroller defines primary capital to include:

Common stock, perpetual preferred stock, capital surplus, undivided profits, reserves for contingencies and other capital reserves (excluding accrued dividends on perpetual and limited life preferred stock), net worth certificates ..., minority interests in consolidated subsidiaries, and allowances for loan and lease losses; minus intangible assets; ... [plus] purchased mortgage servicing rights; and ... mandatory convertible debt to the extent of 20% of the sum of [the above].

Secondary capital is defined to include mandatory convertible debt not included in primary capital and limited life preferred stock and subordinated notes and debentures, to the extent that the total does not exceed 50% of primary capital. Total capital is the sum of primary capital and secondary capital. The regulation provides some flexibility in defining primary and secondary capital, however, by allowing the Comptroller to permit other items, in certain circumstances,

112. Id. at §§ 325.4(b), .6(b). Civil money penalties may be assessed for failure to maintain capital ratios by the FDIC's Board of Review. FDIC Applications, Requests Submittals, Delegations of Authority, and Notices of Acquisition of Control; Rules of Practice and Procedures, 50 Fed. Reg. 11,653 (1985).
113. 12 C.F.R. § 325.4(c).
115. 12 C.F.R. § 3.2(c) (1986).
116. Id. at § 3.2(d).
117. Id. at § 3.2(e).
to constitute the defined amount.\textsuperscript{118} The Comptroller has reserved the ability to authorize either less than or more than the minimum capital, depending on particular banks' circumstances.\textsuperscript{119} The regulation sets out in detail when higher ratios may be necessary\textsuperscript{120} and the procedures for establishing a minimum capital ratio.\textsuperscript{121} The regulation provides sanctions for noncomplying banks, including the issuance of a directive, assessment of penalties and denial or revocation of applications.\textsuperscript{122} The Comptroller prohibits banks from selling loans with recourse to reduce assets and thereby reduce capital requirements.\textsuperscript{123}

3. Federal Reserve Board

The FRB’s minimum capital ratios for FRS member state banks and bank holding companies are the same as those of the other agencies, with a 6% total ratio and a $5\frac{1}{2}\%$ primary ratio.\textsuperscript{124} The FRB, however, continues to view the total capital ratio in terms of three zones — total capital under 6%, between 6% and 7% and over 7%.\textsuperscript{125} The amount of the Board's supervisory action is dependent on the zone in which the bank falls and its compliance with the minimum primary capital ratio. Primary capital includes (subject to certain limitations) common stock, perpetual preferred stock, perpetual debt surplus, undivided profits, contingency and other capital reserves, mandatory convertible instruments, allowances for possible loan and lease losses and minority interests in equity

\begin{itemize}
  \item \textsuperscript{118} Id. at § 3.4.
  \item \textsuperscript{119} Id. at §§ 3.8-3.9-.12.
  \item \textsuperscript{120} Id. at § 3.10.
  \item \textsuperscript{121} Id. at § 3.11-.12.
  \item \textsuperscript{122} Id. at § 3.14.
  \item \textsuperscript{123} See OCC's Clarke Labels Authorization of Bank Securities Powers Number One Priority to Ensure Health of Banking Industry, 43 Wash. Fin. Rep. (BNA) No. 23 at 989, 993 (June 9, 1986).
  \item \textsuperscript{125} 50 Fed. Reg. 16,057, 16,066 (1985) (as modified by FRS, Capital Guidelines; Perpetual Debt as Primary Capital and Limits on Perpetual Debt, Preferred Stock and Mandatory Convertible Securities, 51 Fed. Reg. 40,963 (1986)).
\end{itemize}
accounts of consolidated subsidiaries; intangible assets are deducted from the total of these components. Secondary capital includes limited life preferred stock and qualifying subordinated notes and debentures (up to 50% of primary capital).

As between banks and bank holding companies, the FRB distinguishes its treatment of intangible assets. Banks deduct goodwill in computing the capital ratios and include other intangibles in the capital computations. Bank holding companies are not required to automatically deduct goodwill. Similarly, equity commitment notes (a subordinated debt instrument converted into common stock or perpetual preferred stock) are not treated as capital for banks but are treated as capital for bank holding companies.

The FRB may require particular banks or bank holding companies to maintain a higher than the minimum level of capital. The FRB also sets out detailed procedures of issuing and enforcing directives.

4. Differences Among the Agency Rules and Regulations

Both the FDIC's and the Comptroller's capital adequacy standards were codified into a regulation, whereas the FRB's standards remain as a policy statement. The FRB noted that its decision to issue only a policy statement stems from the "need for flexibility in applying minimum capital ratios and even in defining 'capital.'" Another difference in the standards is the time requirements set out for banks to respond to directives. The FDIC allows a bank fourteen days to respond, the Comptroller allows thirty days and the FRB does not set any time limit for responding to the Board but will set the limits in each individual case. A third difference among the agencies is the zone concept the FRB uses in addition to the minimum capital levels.

126. Id. at 16,067.
127. Id.
128. Id. at 16,068.
129. Id. 16,069-70.
131. 12 C.F.R. § 325.6(b)(2).
132. Id. at § 3.17 (1986).
The agencies generally, however, will use the same capital definitions and have the same ratios. All three agencies also treat all banking organizations in the same manner, regardless of size. The new standards should, therefore, provide a great deal of uniformity in the regulation of capital adequacy of banking institutions.

5. Federal Home Loan Bank Board Net Worth Requirements

The FHLBB as trustee for the FSLIC has the authority to require capital for insured institutions.\textsuperscript{133} Under this authority the FHLBB promulgated regulatory capital rules that increase the capital requirement from 3\% of liabilities to 6\% according to industry profitability over the next six to twelve years.\textsuperscript{134}

The annual capital requirements will be determined by a percentage of the industry's return of assets during the preceding year. Beginning in April 1987, the FHLBB will calculate the 1986 return on assets. For institutions with 3\% or more in regulatory capital, the capital level will increase by 75\% of the 1986 return on assets. For institutions with less than 3\% in regulatory capital, the capital level will increase by 90\% of the 1986 return on assets. Many de novo institutions have been required to maintain capital levels that are higher than other institutions; de novo institutions will be required to maintain the higher of their de novo standard or 6\% of liabilities. Special rules apply to growth through mergers or acquisitions. Institutions are required to calculate and meet

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\textsuperscript{133} 12 U.S.C. § 1726(b). Savings and Loan associations may now include in their net worth nonpermanent preferred stock which is redeemable at the option of the issuer. The associations may also include in their net worth redeemable preferred stock with mandatory redemption. FHLBB, Preferred Stock as Regulatory Net Worth, 50 Fed. Reg. 46,739 (1985).

\textsuperscript{134} Under the new regulation, effective January 1, 1987, capital is called "regulatory capital." Under the former regulation the term was "regulatory net worth." 12 C.F.R. § 563.13 as set forth in FHLBB, Regulatory Capital (Net Worth) Requirements of Insured Institutions, 51 Fed. Reg. 33,565 (1986).
their regulatory capital requirements each quarter beginning with the first quarter of 1987.\textsuperscript{135}

Higher regulatory capital ratios are required of institutions that have direct investments, land loans, construction loans and letters of credit. Institutions are divided into three categories to determine the contingency components: (i) Institutions that do not meet the 3\% capital requirements; (ii) institutions that meet current requirements but have capital less than 6\% of their phased-in requirement level; and (iii) institutions that are capitalized at the phased-in level or 6\%.

The capital reserves for direct investments and loans are as follows:

<table>
<thead>
<tr>
<th>Category of Institution</th>
<th>Direct Investments\textsuperscript{136}</th>
<th>Land Loans &amp; Nonresidential Construction Loans\textsuperscript{137}</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i)</td>
<td>-10% of investments</td>
<td>-4% of loans</td>
</tr>
<tr>
<td>(ii)</td>
<td>-5% of investments up to 10% of assets</td>
<td>-2% of loans up to 10% of assets</td>
</tr>
<tr>
<td></td>
<td>-10% of additional investments</td>
<td>-4% of loans over 10% of assets</td>
</tr>
<tr>
<td>(iii)</td>
<td>-No reserve up to 10% of assets</td>
<td>-No reserve up to and including 10% of assets</td>
</tr>
<tr>
<td></td>
<td>-5% for second 10% of assets</td>
<td>-2% for more than 10% and less than 20% of assets</td>
</tr>
<tr>
<td></td>
<td>-10% for additional investments</td>
<td>-4% for more than 20% of assets</td>
</tr>
</tbody>
</table>

A 2\% capital reserve is required for all institutions that issue standby letters of credit.\textsuperscript{138}

\textsuperscript{135} 12 C.F.R. § 563.13(b)(8) & (9), 12 C.F.R. § 563.13(c)(2), 12 C.F.R. § 563.13(c)(3), and 12 C.F.R. § 563.13(c)(1). The Principal Supervisory Agent had delegated authority to convert the net worth calculation to the standard net worth computation. The FHLBB has terminated that delegated authority and the Board will now directly supervise that conversion. FHLBB, Net-Worth Requirements of Insured Institutions, 51 Fed. Reg. 15,876 (1986).

\textsuperscript{136} 12 C.F.R. § 563.13(b)(10)(iii)(A).

\textsuperscript{137} Id. at § 563.13(b)(10)(iv)(A) and (b)(10)(v)(A).

\textsuperscript{138} Id. at 12 C.F.R. § 563.13(b)(10)(vi).
The capital rules also clarify the liability growth rules. Unless an institution has capital equal to the higher of 6% of liabilities or its phased-in capital requirement, liability growth is limited to a growth rate of 12.5% within two quarter periods. Prior regulatory approval is required to exceed the growth rates.\textsuperscript{139}

Federal savings and loan associations are authorized to issue notes, bonds, debentures or other securities (including capital stock).\textsuperscript{140} Wholly-owned finance subsidiaries of federal S&L's as an incidental power to the parent's authority may also issue securities. The FHLBB has modified its rules relating to the issuance of securities by finance subsidiaries.

The creation of a finance subsidiary must be expressly authorized by the board of directors of the parent S&L by means of a business plan. The S&L may capitalize the subsidiary without FHLBB approval by transferring assets that (i) do not exceed 30% of the S&L's assets; and (ii) do not have a market value exceeding the lesser of (a) the amount necessary and customary to a particular type of securities issuance, or (b) 250% of the issuance. The securities may be sold by third parties. This rule permits small S&Ls to have better access to capital markets.

An S&L may guarantee the unpaid balance of the subsidiary's obligation; however, the subsidiary's assets must be exhausted prior to recourse to the guarantee. A finance subsidiary is prohibited from (i) dealing in the accounts of the parent S&L; (ii) stating that its securities are insured by the FSLIC or (iii) issuing securities that accelerate upon the parent S&L's insolvency. The finance subsidiary is not consolidated with the parent S&L for the calculation of the S&L's net worth. The FHLBB receives notice of creation of the subsidiary, transfer of assets to the subsidiary, and issuance of securities.\textsuperscript{141}

\textsuperscript{139} Id. at § 564.13-1.
\textsuperscript{140} 12 U.S.C. § 1464(b)(2).
6. Risk-Based Capital Proposals

The FRB, FDIC and Comptroller have each recently published for comment proposed "risk-based capital" plans. The FRB's and FDIC's joint proposal would supplement their existing capital adequacy regulations. The Comptroller's proposal would replace, in its entirety, the existing capital adequacy regulation. However, these regulators still have as an objective the issuance of final joint risk-based capital rules.

The Comptroller's proposed regulation basically parallels that of the FRB and FDIC by factoring into capital requirements the riskiness of bank assets into capital calculations and by requiring banks to hold capital against certain off-balance sheet items such as standby letters of credit, binding loan commitments, interest rate swaps and foreign exchange risks. This latter treatment of such off-balance sheet items may have the effect of increasing institutional costs of certain commercial lending activities.

Four categories of bank assets and certain off-balance sheet items would be established, with relative weights being assigned to each category: cash and cash equivalents (0%), money market risk (30%), moderate risk category (60%), and standard risk category (100%). The dollar value of items in each category would be multiplied by the category's risk weight in order to determine the measure of risk-weighted assets for a particular bank.

Under the Comptroller's plan, it would be possible for certain banks to operate below the present minimum 5 1/2% primary capital ratio. The Comptroller is, however, considering whether certain "classified" assets should be deducted from a bank's primary capital and whether loan reserves

144. Id. at 10,606.
146. 51 Fed. Reg. 10,602, 10,603.
147. Id. at 10,604-05, table 2, for illustration.
148. Id. at 10,602.
should be excluded from such capital. The FHLBB's recent net worth rules also factor in a "risk-based" concept.

F. Asset Classification and Allowances for Losses

The various bank regulators employ loan classification in their examination procedures. For example, the Comptroller, FDIC, FRB and the Conference of State Bank Examiners have adopted "Uniform Guidelines" for the classification of loans. These classifications are:

*Substandard* asset, which includes a loan inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. These assets have well-defined weaknesses that jeopardize the liquidation of the debt and are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

*Doubtful* asset, which includes a loan that has all the weaknesses inherent in one classified as "substandard," with the added characteristic that the weaknesses make collection or liquidation in full highly questionable and improbable. Fifty percent of the total of "doubtful" loans are deducted in computing a bank's required capital.

*Loss* asset, which includes a loan considered uncollectible and of such little value that its continuance as a bankable asset is not warranted. A loss loan may have some salvageable value; however, a determination is made that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. All of the "loss" is to be deducted in computing a bank's required capital.

The Federal Home Loan Bank Board has adopted similar loan evaluation rules. Loans classified as "loss" cause the S&L to reserve 100% of the loan, loans classified as "doubtful" cause the S&L to reserve 50% of the loan and loans classified as "substandard" (i.e., a "scheduled" item) cause the S&L to

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149. Id. at 10,605-06.
150. See supra notes 133-41.
increase its net worth by an amount equal to 20% of the asset’s value. The absence of an appraisal or an inadequate appraisal may cause loans otherwise not classifiable for credit reasons to be classified. Certain S&L assets are not evaluated by these standards: consumer loans, loans secured by one-to-four family owner occupied homes and nonreal estate securities.\textsuperscript{152}

Related to the classification of assets is the responsibility of management of banking institutions to maintain an adequate allowance for loan losses and lease losses (ALLL) and to establish and follow a system of written procedures to ensure complete analysis of all factors pertinent to the evaluation of the ALLL.\textsuperscript{153} Failure to do so could result in an institution’s filing a false or misleading regulatory report (i.e., a “call report”) or financial statement,\textsuperscript{154} which could lead to regulatory action (including a cease and desist order, civil money penalties, or a suspension or removal order)\textsuperscript{155} or, in certain instances could result in a securities law violation.\textsuperscript{156}

\textbf{G. Institutional Ratings (CAMEL and BOPEC)}

An essential part to a banking institution’s regulatory rating is the quality of its loan and investment portfolio. This rating can well determine the extent and nature of the examination process and supervisory and remedial actions taken by the relevant regulator. As such, a bank’s rating can affect its future ability (in terms of “safety and soundness” criteria) to engage in certain types and/or certain amounts of lending activities.

In 1978, the FRB, FDIC and Comptroller agreed on Guidelines on a Uniform Interagency Bank Rating System (CAMEL), which is generally followed by most state bank regulators. CAMEL has two basic aspects: (i) an assessment by bank examiners of five key factors of a bank’s operations and

\begin{itemize}
  \item \textsuperscript{152} FHLBB, Classification of Assets, 50 Fed. Reg. 53,275 (1986).
  \item \textsuperscript{153} See, e.g., Comptroller of the Currency, Banking Circular No. 201 (May 31, 1985).
  \item \textsuperscript{154} See, e.g., 12 U.S.C. § 161 (1982).
  \item \textsuperscript{155} See, e.g., \textit{id.} at §§ 1818(b) & (c) (1982 & Supp. I 1983).
  \item \textsuperscript{156} See, e.g., \textit{In re} Utica Bankshares Corp., SEC Release No. 20,702 (Feb. 29, 1984).
\end{itemize}
conditions; capital adequacy ("C"), asset quality ("A"), management ("M"), earnings ("E") and liquidity ("L") (ii) an evaluation of these factors to arrive at a composite, overall rating of the bank's condition and soundness into one of five categories.

Each of the five key factors is to be rated on a one-through-five basis:

Rating No. 1 — indicates strong performance. It is the highest rating and is indicative of performance significantly higher than average.

Rating No. 2 — reflects satisfactory performance. It reflects performance that is average or above average; it includes performance that adequately provides for the safe and sound operation of the bank.

Rating No. 3 — represents performance flawed to some degree; as such, is considered fair. It is neither satisfactory nor marginal but is characterized by performance of below average quality.

Rating No. 4 — represents marginal performance significantly below average; if left unchecked, such performance might evolve into weaknesses or conditions that could threaten the viability of the institution.

Rating No. 5 — is considered unsatisfactory. It is the lowest rating and is indicative of performance critically deficient and in need of immediate remedial attention. Such performance by itself, or in combination with other weaknesses, could threaten the viability of the institution.\textsuperscript{157}

In terms of the composite bank rating, a one-through-five system is also used:

Composite 1. Banks in this group are sound institutions in almost every respect; any critical findings are basically of a minor nature and can be handled in a routine manner. Such banks are resistant to external economic and financial disturbances and capable of withstanding the vagaries of business conditions more ably than banks with lower composite ratings.

Composite 2. Banks in this group are also fundamentally sound institutions but may reflect modest weaknesses

correctable in the normal course of business. Such banks are stable and also able to withstand business fluctuations quite well; however, areas of weakness could develop into conditions of greater concern. To the extent that the minor adjustments are handled in the normal course of business, the supervisory response is limited.

Composite 3. Banks in this group exhibit a combination of weaknesses ranging from moderately severe to unsatisfactory. Such banks are only nominally resistant to the onset of adverse business conditions and could easily deteriorate if concerted action is not effective in correcting the areas of weakness. Consequently, such banks are vulnerable and require more than normal supervision. Overall strength and financial capacity, however, are still such as to make failure only a remote possibility.

Composite 4. Banks in this group have an immoderate volume of asset weaknesses or a combination of other conditions that are less than satisfactory. Unless prompt action is taken to correct these conditions, they could reasonably develop into a situation that could impair future viability. A potential for failure is present but is not pronounced. Banks in this category require close supervisory attention and financial surveillance.

Composite 5. This category is reserved for banks whose conditions are worse than defined under No. 4 above. The volume and character of weaknesses are such as to require urgent aid from the shareholders or other sources. Such banks require immediate corrective action and constant supervisory attention. The probability of failure is high for these banks.158

The FRB also emphasizes a component and composite one-through-five rating system for bank holding company units (BOPEC).159 In arriving at an overall assessment of financial condition, the FRB evaluates the following elements on a scale of one through five, in descending order of performance quality: (i) bank subsidiaries ("B"); (ii) other (non bank) subsidiaries ("O"); (iii) parent company ("P"); (iv) earnings,

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158. Id.
consolidated ("E") and (v) capital adequacy, consolidated ("C").

The five composite rating categories are:

Composite 1. Bank holding companies in this group are sound in almost every respect; any negative findings are basically of a minor nature and can be handled in a routine manner. Such holding companies and their subsidiaries are resistant to external economic and financial disturbances and readily generate cash flow more than adequate to service their debt and other fixed obligations with no harm to subsidiaries.

Composite 2. Bank holding companies in this group are also fundamentally sound but may reflect modest weaknesses correctable in the normal course of business. Such holding companies and their subsidiaries generate cash flow adequate to service their obligations; however, areas of weakness could develop into conditions of greater concern. To the extent that the minor adjustments are handled in the normal course of business, the supervisory response is limited.

Composite 3. Bank holding companies in this group exhibit a combination of weaknesses ranging from fair to moderately severe. Such holding companies and their subsidiaries are less resistant to the onset of adverse business conditions and could likely deteriorate if concerted action is not effective in correcting the areas of weakness. The company's cash flow is sufficient to meet immediate obligations but, unless action is taken to correct weaknesses, parent cash flow needs could adversely affect the financial condition of the subsidiaries. Consequently, such bank holding companies are vulnerable and require more than normal supervision. Overall strength and financial capacity, however, still pose only a remote threat to the viability of the company.

Composite 4. Bank holding companies and their subsidiaries in this group have an immoderate volume of asset weaknesses or a combination of other conditions that are less than satisfactory. An additional weakness may be that the holding company's cash flow needs are met only by upstreaming imprudent dividends and/or fees from its subsidiaries. Unless prompt action is taken to correct these conditions, they could

160. Id.
impair future viability. Bank holding companies in this category require close supervisory attention and increased financial surveillance.

Composite 5. The volume and character of the weaknesses of bank holding companies in this category are so critical as to require urgent aid from shareholders or other sources to prevent insolvency. The imminent inability of such companies to service their fixed obligations and/or to prevent capital depletion from severe operating losses places their viability seriously in doubt. Such companies require immediate corrective action and constant supervisory attention.161

H. Proposed Federal Home Loan Bank Board Geographic Restrictions

On April 24, 1986, the FHLBB, in an effort to minimize risks within the thrift industry, issued a controversial proposal that would restrict nationwide lending and loan participations by federally regulated thrift institutions.162 Effectively such institutions would be prohibited from purchasing whole nationwide loans outside their normal lending territories from sellers with deficient capital or portfolio performance. Thrifts with capital or portfolio weakness would be permitted to engage in nationwide lending only in conjunction with business plans approved by a principal supervisory agent.163 If finally enacted this proposal would be a form of regulatory control, on a geographic basis over a thrift’s lending activities.

IV. Single Borrower Lending Limits

Banking institutions are often subject to statutes restricting loan amounts to a single borrower.

161. Id.


163. For discussion of proposal, see Bank Board Revises Controversial Nationwide Lending Proposal, 46 Wash. Fin. Rep. (BNA) No. 20, at 838 (May 19, 1986) (subsequent to the preparation of this article the FHLBB has withdrawn this proposal).
A. National Banks

The National Bank Act contains a specific limitation, under 12 U.S.C. § 84, on the amount of money that may be loaned to a single borrower. This limitation is commonly referred to as the "single borrower" limitation. The primary objective of this limitation is to safeguard the bank's depositors by spreading the loans among a relatively large number of persons engaged in different lines of business.¹⁶⁴

1. The General Lending Limit Rule

The limitation under 12 U.S.C. § 84 originally provided that "total obligations" to a single borrower could not exceed 10% of the bank's unimpaired capital and surplus. However, § 401 of the 1982 Banking Act amends, in its entirety, 12 U.S.C. § 84.¹⁶⁵ The most fundamental changes in the law are an increase in the general statutory ceiling from 10% to 15% of a national bank's unimpaired capital and surplus, the creating of an additional secured 10% ceiling and the adoption of newly defined general terms. Some prior statutory exceptions have been deleted while other exceptions are preserved, with some alteration of terms or integration elsewhere into the statute. An additional statutory exception for loans secured by segregated deposit accounts was also enacted.

The 1982 Banking Act confers upon the Comptroller authority to prescribe implementing regulations and to issue rules for aggregation or combination of loans. In April 1983, the Comptroller issued its Revised Rule on Lending Limits (the revised regulation) to implement the Act.¹⁶⁶


The ability of national banks to allocate within a bank holding company unit is dealt with and modified by the 1982 Banking Act's revisions to section 23A of the Federal Reserve Act.167

(a) Structural Changes

The 1982 Banking Act restructured section 84 to address separately limits for loans and extensions of credit that are unsecured168 and secured.169 Subsection (b) of section 84 contains definitions of terms used throughout the section. Subsection (c) enumerates ten exceptions to the general limits of subsections (a)(1) and (2). Subsection (d) authorizes the Comptroller to administer and carry out the purposes of the section and to provide rules concerning the aggregation of loans.

(b) Definitional Changes

The 1982 Banking Act includes a number of significant definitions.

(1) Loans and Extensions of Credit

The 1982 Banking Act amends section 84 to apply to the “total loans and extensions of credit” by a national association and its domestic operating subsidiaries to a single customer. “Loans and extensions of credit” are defined as:

all direct or indirect advances of funds to a person made on the basis of any obligation of that person to repay the funds repayable from specific property pledged by or on behalf of the person and, to the extent specified by the Comptroller of the Currency, such term shall also include any liability of a national banking association to advance funds to or on behalf of a person pursuant to a contractual commitment . . . .170

167. See infra notes 304-40 and accompanying text.
169. Id. at § 84(a)(2).
The 1982 Banking Act thus utilizes a broader definition for applicable transactions. The act gives the Comptroller of the Currency the authority to determine when a contractual commitment to advance funds should be included in a person's liability.  

(2) Person

Section 84, as amended by the 1982 Banking Act, refers to loans and extensions of credit outstanding at any one time to a particular “person.” This term is defined for the first time and includes: “an individual, sole proprietorship, partnership, joint venture, association, trust, estate, business trust, corporation, sovereign government or agency, instrumentality, or political subdivision thereof, or any similar entity or organization.” Thus the definition includes individuals and most forms of entities. In addition, the revised regulation clarifies that non-profit corporations and estates are included as “persons.”

(c) Nonrelation to Investment Limitations

Under the 1982 Banking Act, the lending limits are separate and distinct from the investment limits applicable to national banks. A national bank may make loans to a customer up to the applicable lending limit and may own investment securities issued by the same customer to the extent that the investment is permitted by statute or regulation.

2. Loans and Extensions of Credit and Exceptions

The revised regulation provides that a national bank may grant loans and extensions of credit up to 15% of its unimpaired capital and unimpaired surplus to any “person.” A national bank may also grant additional loans and extensions of credit to a single person up to 10% of its unimpaired capital and surplus, provided that the transactions will be

171. Id.
172. Id. at § 84(b)(2) (Supp. I 1983).
173. 12 C.F.R. § 32.2(b) (1986).
174. See id. at § 32.111.
fully secured by readily marketable collateral having a marketing value, as determined by reliable and continuously available price quotations.\textsuperscript{176} The definition of "loans and extension of credit" has already been discussed. Unimpaired capital and surplus of a national bank have the same meaning as given to such terms under the new Comptroller Capital Adequacy Regulations.\textsuperscript{177}

\textit{(a) Commitments and Advances}

Within the definition of a "loan and extension of credit" is a "contractual commitment to advance funds" by a national bank. Under the 1982 Banking Act, the Comptroller was granted the authority to determine when a "contractual commitment to advance funds" should be included in a person's liability under the lending limit rules.\textsuperscript{177} Under the revised regulation, "contractual commitment to advance funds" means: (1) an obligation of the bank to pay a third party upon default by the bank's customer to perform under a contract or (2) an obligation by the bank to guarantee or to stand as a surety for the benefit of a third party.\textsuperscript{178}

Some types of commitments are treated in the same manner as a loan for lending limit purposes and are subject to all the section 84 exceptions. Such commitments include letters of credit, surety obligations, guaranties, puts and similar obligations of the bank. For purposes of this provision, a standby letter of credit is an arrangement that represents an obligation by the issuing bank to repay funds borrowed by, or advanced to, the bank's customer; to make payment on an obligation undertaken by the customer; or to make payment on an obligation defaulted upon by the customer.\textsuperscript{179} Bank guaranties of obligations of affiliates are governed by section 23A of the Federal Reserve Act and not by the lending limit rules.\textsuperscript{180}

\begin{flushright}
\textsuperscript{175} 12 U.S.C. § 84(a)(2). \textit{See infra} notes 203-08 and accompanying text for a discussion of the additional 10% secured limit.  \\
\textsuperscript{176} \textit{See supra} notes 114-23 and accompanying text.  \\
\textsuperscript{177} 12 U.S.C. § 84(b)(1).  \\
\textsuperscript{178} \textit{See} 12 C.F.R. § 32.2(d) (1986).  \\
\textsuperscript{179} \textit{See id. at} § 32.2(e).  \\
\textsuperscript{180} \textit{See infra} notes 304-40 and accompanying text.
\end{flushright}
A common instrument excepted from the lending limit is a commercial letter of credit and similar instruments through which the issuing bank "expects the beneficiary to draw upon the issuer; does not 'guarantee' payment of the money; and does not provide for payment in the event of default by the account party (the bank customer)."¹⁸¹

Under the revised regulation, the Comptroller has retained (through a definitional exclusion) the prior provisions under which undisbursed loan funds and undisbursed loan commitments are not considered loans for lending limit purposes.¹⁸² As prudent bank procedure, the Comptroller suggests in the supplementary information to the revised regulation that a bank maintain adequate internal procedures to monitor commitments made to ensure that disbursals do not exceed the lending limits at any time.

(b) Overdrafts

Overdrafts and advances of funds against uncollected balances are "loans and extensions of credit" subject to the lending limit. This rule applies to any overdraft whether "inadvertent" or "insignificant." The only exception to the rule is in relationship to "intra-day" or "daylight" overdrafts.¹⁸³

(c) Third-Party Paper

When a national bank purchases third-party paper under a repurchase agreement that obligates the seller to repurchase the paper in the event of a default or at the end of a stated period after default, the seller's repurchase agreement is subject to the lending limit applicable to such seller. The transaction is measured under section 84 by the total outstanding balance of the paper less any seller's reserve. If the seller agrees to a limited repurchase agreement, the seller's loans or extensions of credit are measured by the amount of paper the seller may be obligated to repurchase. If the bank has no recourse against the seller and retains a portion of the paper's

¹⁸¹. See 12 C.F.R. § 32.2(d); see also OCC, Staff Interpretive Letter, [Current] Banking L. Rep. (CCH) ¶ 85,531 (May 22, 1986).
¹⁸². 12 C.F.R. § 32.2(d).
¹⁸³. See id. at § 32.105.
purchase price as collateral, then the paper is not a loan or extension of credit to the seller.\textsuperscript{184}

The purchase of third-party paper does not come within the definition of "loans and extensions of credit" under 12 U.S.C. § 84; therefore, the Comptroller asserts that the purchase of third-party paper is not an "extension of credit" under 12 U.S.C. § 375a and the Federal Reserve Board's Regulation. This assertion is made even though the regulation does not specifically incorporate the Comptroller's interpretation of section 84.\textsuperscript{185}

A proposal by a national bank to purchase notes issued by a financial institution from third-party holders of the notes constitutes a loan to the financial institution. The presence of a repurchase agreement from the holders does not modify the aggregation of the notes to the financial institutions.\textsuperscript{186}

\textbf{(d) Open Accounts}

Under the revised regulation, national banks are authorized to purchase open accounts or accounts receivable. Accounts receivable represent a right to payment for goods or services. Evidence of this right to payment may be documented by notes, drafts, invoices, purchase orders or account entries. In order that a sale of open accounts to a national bank not be considered obligations of the seller subject to the lending limit, the seller must indorse the paper without recourse.\textsuperscript{187}

\textbf{(e) Personal Property Leases}

Under the revised regulation, personal property leases financed by a national bank are obligations subject to the lending limit. The limit applies to funds actually advanced under

\begin{enumerate}
\item[184.] See id. at § 32.104.
\item[187.] See 12 C.F.R. § 7.1105 (1986).
\end{enumerate}
a lease. To determine whether a national bank may grant additional loans and extensions of credit to a person, funds advanced to the customer under all outstanding leases must be taken into account. This calculation includes leases consummated prior to June 12, 1979, the effective date of the interpretive ruling concerning personal property leases. Lease renewal agreements entered into prior to this date may be honored without violation of the lending limit.\textsuperscript{188}

(f) Third-Party Guaranties

The accommodation party provision of the revised regulation merely states:

The liability of a drawer, endorser or guarantor who does not receive any of the proceeds, or the benefit of the proceeds, of the loan or extension of credit is not a loan or extension of credit to such person for purposes of this part unless one of the ["common enterprise"] tests \ldots is satisfied.\textsuperscript{189}

Therefore, the tests under the revised regulation appear to be whether the guarantor receives any of the proceeds or the benefit of the proceeds, or is engaged in a common enterprise with the borrower.\textsuperscript{190}

Introduced into the revised regulation’s provisions on third-party guaranties is the concept of receiving the “benefit” of the proceeds (a test previously applied by the Comptroller on an informal basis). The application of this test does not appear entirely clear. Absent further guidance from the Comptroller’s Office, and in light of the specific inclusion of the term “benefit of the proceeds” in the revised regulations, a bank may wish to consider taking the conservative position that third-party guaranties by dominant shareholders or dominant partners of a borrower would be deemed to be “loans or extensions of credit” for lending limit purposes.

\textsuperscript{188} See id. at § 7.3400.
\textsuperscript{189} See id. at § 32.101.
\textsuperscript{190} Cf. id. at § 7.1125(b); OCC, Staff Interpretive Letter, [Current] Fed. Banking L. Rep. (CCH) ¶ 85,461 (May 4, 1984). Notwithstanding the foregoing, this author abides by his analysis of the regulation.
A national bank may reduce its loans and extensions of credit (which include loans, the discount of its own acceptances and standby letters of credit) by selling a nonrecourse participation. Such a participation must share the credit risk in proportion to the interests of the participants. Last-in-first-out (LIFO) participations can reduce the outstanding loans of the seller but must provide for bona fide sharing of risk in the event of a default or a comparable event defined in the participation agreement. In light of these requirements, a bank may wish to reexamine its standard participation agreements used in relevant circumstances.

(h) Accrued or Discounted Interest

Under the revised regulation, the amount of loans or extensions of credit subject to the lending limits does not include accrued or discounted interest.

(i) Charge-Offs, Unenforceable Obligations

The lending limits apply to transactions charged off the bank's records but does not apply to obligations that have become unenforceable by reason of a discharge in bankruptcy or being no longer legally enforceable. Transactions in the latter category may become unenforceable due to: (i) the expiration of the statute of limitations, (ii) judicial decision or (iii) regulatory order. The Comptroller recommends that an opinion of counsel indicating that the loan or extension of credit is no longer legally enforceable be obtained prior to taking advantage of this new exception.

(j) General Obligation Loans

A loan or extension of credit granted to a state or political subdivision that constitutes a "general obligation" of the

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193. See id. at § 32.106.
entity is excepted from the lending limit. Similarly, a transaction guaranteed or fully secured by a “general obligation” is excepted from the lending limit. A bank entering into such a loan should obtain the opinion of counsel that such arrangements are valid and enforceable obligations of the borrower.194

(k) Loans to Industrial Development Authorities

Extensions of credit to an industrial development authority or similar public entity created for the purpose of constructing and leasing facilities to industrial occupants, including health care facilities, are not loans or extensions of credit to the authority if certain criteria are met. Such transactions are considered loans to the lessee (industrial occupant) if:

The bank relies on the credit of the industrial occupant in making the loan; . . . the authority’s liability with respect to the loan is limited solely to whatever interest it has in the particular facility; . . . the authority’s interest is assigned to the bank as security for the loan or a note from the lessee to the bank provides a higher order of security than the assignment of the lease; and . . . the industrial occupant’s lease rentals are assigned and paid directly to the bank.195

(l) Federal Funds

Federal reserve funds sold by a national bank to another depository institution may not be subject to the lending limit. Historically, the term “federal funds” referred to the balance of a bank’s reserve account with a Federal Reserve bank in excess of its reserve requirement. These funds were made available for sale to other financial institutions experiencing a reserve deficiency, usually on a one day basis. Currently, federal funds transactions are the disposal of excess reserve balances or other immediately available funds for one business

194. See id. at § 32.109.
195. See id. at § 32.110. The Comptroller’s Office has opined that a bank’s purchase of industrial revenue bonds without recourse against the selling bank (but accompanied by a “bond-sale option agreement”) constitutes a borrowing for purposes of 12 U.S.C. § 84 (Ltr. No. 262, dated June 27, 1983). Also, industrial revenue bonds where an issue held by one holder or a small group of local holders are treated as loans. OCC, Staff Interpretive Letters, [Current] Fed. Banking L. Rep. (CCH) ¶ 85,263 and ¶ 85,426 (Mar. 10, 1981 and June 17, 1983).
day or under a continuing contract. A continuing contract is an agreement that remains in effect for more than one business day but has no specified maturity and does not require advance notice to terminate. These transactions are not subject to the lending limit. However, the Comptroller has ruled that federal funds transactions of a longer duration are subject to the lending limit.\textsuperscript{196}

\textit{(m) Securities (Repurchase Agreements)}

Purchases of a list of fifteen specified "Type I" investment securities\textsuperscript{197} by a national bank under an agreement to resell at the end of a stated time period are not subject to the lending limit.\textsuperscript{198} All other types of securities purchased under these agreements are obligations subject to the lending limit.\textsuperscript{199}

\textit{(n) Loans by Bank Foreign Subsidiaries or by Edge Act Corporations}

Loans or extensions of credit granted by bank-owned foreign subsidiaries or by Edge Act corporations are not combined with bank transactions with the same borrowers for section 84 lending limit purposes. The principal reason behind this decision is that the imposition of the lending limit on foreign subsidiaries would place banks at a competitive disadvantage in foreign markets. However, the FRB regulation K separately provides for a 10\% limitation on loans by an Edge Act corporation and its subsidiaries to any person and separately requires that the liabilities of any one person to a majority-owned foreign bank or Edge Act corporation be combined for FRB lending limit purposes with liabilities of the same person to the FRB member bank.\textsuperscript{200}

\textsuperscript{196} See 12 C.F.R. § 32.102 (1986).
\textsuperscript{197} See id. at § 1.3(c).
\textsuperscript{198} See id. at § 32.103(a).
\textsuperscript{199} See id. at § 32.103(b).
\textsuperscript{200} See id. at § 211.6(b)(ii).
(o) Loans to Bank Affiliates

Another exception by virtue of another statute is loans by national banks to their "affiliates." Congress preempted the application of section 84 to transactions with affiliates with the passage of a simplified and stricter section 23A of the Federal Reserve Act.201

(p) Loans by Domestic Operating Subsidiaries

Loans and extensions of credit made to a borrower by a national bank's domestic operating subsidiaries are consolidated with loans to the same borrower by the bank under section 84.202

3. The 10% Secured Limit and Other Additional Limits

The 1982 Banking Act and the revised regulation provide for certain limits in addition to the 15% unsecured limit. Loans secured by collateral under the additional 10% general limit must be secured by readily marketable collateral having a current market value of 100% of the loan or extension of credit.203

(a) The Type of Collateral

The permitted collateral must be "readily marketable" financial instruments such as: instruments traded on a national security exchange including stocks, notes, bonds and debentures; OTC margin stocks; commercial paper; negotiable certificates of deposit; banker's acceptances; and shares in money and mutual funds of the type that issue shares in which a bank may perfect a security interest. Bullion also qualifies as readily marketable collateral.204

(b) Valuation

Valuation of the permitted collateral is determined by quotations based on actual transactions on an auction or a

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204. See 12 C.F.R. § 32.4(c).
similarly available daily bid-and-ask-price market. The Comptroller has abandoned its attempt set forth in the December, 1982 proposed regulation to require 115% of collateral value. Under the revised regulation, if the collateral value falls below 100% of the outstanding loan, the loan must be brought into conformance within five business days. If conformance is not made within this time period, a violation of the law occurs. Exceptions are granted to the five-day rule in only the case of judicial proceedings, regulatory actions or other extraordinary occurrences that prevent the bank from taking action. A national bank is required to implement adequate internal procedures to ensure that the collateral value requirement is met at all times.

Financial instruments in foreign currencies convertible into United States dollars must be revalued against foreign exchange rates and repriced against the current market value monthly.

(c) Other Concerns

Because of maintenance of "full security" and avoidance of a shortfall, a bank may wish to consider requiring, as prudent banking practice, more than the 100% requirement and/or may wish to adjust its standard loan forms to include provisions for the prompt furnishing of additional collateral in shortfall situations or (in lieu thereof) a corresponding paydown of the indebtedness.

National banks and their borrowers may be unable to utilize fully this "full security" provision of the general limit due to limitations set forth in other laws. One such limitation is set forth in the Federal Reserve Act and generally provides that the FRB may fix the percentage of each Federal Reserve System member bank loans secured by stocks or bonds. The other law, the Securities Exchange Act of 1934, as amended, authorizes the FRB to regulate credit extended for the purpose of carrying securities.

205. See id. at § 32.4(f).
206. See id. at § 32.4(d).
208. See 15 U.S.C. § 78g(d); 12 C.F.R. § 221 (Reg. U); see also infra text accompanying notes 341-400.
(d) Other Additional Limits

The 1982 Banking Act and the revised regulation provide additional lending authorization over the basic 15% limit for the following transactions:

(1) Loans and extensions of credit arising from the discount of negotiable or non-negotiable installment consumer paper carrying the full recourse indorsement or unconditional guarantee of the party discounting or transferring the same may be made to the extent of 10% of capital and surplus in addition to the 15% limit for a total of 25% of the capital account.209

(2) Loans secured by warehouse receipts, bills of lading or similar documents covering readily marketable commodities may be made to the extent of 35% of the capital and surplus in addition to the 15% limit, provided that the market value of the commodities securing the transaction are at least 115% of the outstanding amount of the loan extended and the commodities are fully insured when it is customary to do so.210

(3) Certain types of loans when secured by livestock may be made in an amount of 10% of the capital account in addition to the 15% limit if they meet certain tests.211

4. The Aggregation Rules

Section 84 no longer specifically addresses the combination or aggregation of loans to a separate borrower. The amended statute authorizes the Comptroller to determine when loans are to be combined.212 Pursuant to the statutory grant of authority, the Comptroller has issued aggregation rules in the revised regulation. The rules became effective on June 14, 1983, and are codified at 12 C.F.R. § 32.5.

The aggregation rules consist of a general rule and separate special rules for corporations, partnerships and other associations and foreign governments, their agencies and instrumentalities. The rules replace in their entirety prior

209. See 12 U.S.C. § 84(c)(8); 12 C.F.R. § 32.6(h).
210. See 12 U.S.C. § 84(c)(3); 12 C.F.R. § 32.6(c).
211. See 12 U.S.C. § 84(c)(9); 12 C.F.R. § 32.6(i).
aggregation rules under 12 C.F.R. § 7.1310 (corporations), § 7.1320 (partnerships and associations) and § 7.1330 (foreign governments).\textsuperscript{213}

(a) The General Rule

The general rule applicable to all situations not specifically provided for in the revised regulation is that loans or extensions of credit are to be combined with those to other persons when "the proceeds of the loans or extensions of credit are to be used for the direct benefit of the other person or persons or . . . a 'common enterprise' is deemed to exist between the persons."\textsuperscript{214}

The revised regulation substantially modifies the Comptroller definition of "common enterprise" as contained in its December, 1982, proposed rules.\textsuperscript{215} For purposes of the general aggregation rule, and otherwise for purposes of the other aggregation rules, a "common enterprise" exists per se:

(ii) Where the expected source of repayment for each loan or extension of credit is the same for each person . . . . [or]

(iii) Where loans or extensions of credit are made to persons who are related through common control, including where one person is controlled by another person, . . . [and] such persons are engaged in interdependent businesses or there is a substantial financial interdependence among them.\textsuperscript{216}

Control is presumed to exist when:

(A) One or more persons acting in concert directly or indirectly own, control, or have power to vote 25% or more of a class of voting securities of another person; or

\textsuperscript{213} 12 C.F.R. § 32.5(b), (c) & (d) (1986).
\textsuperscript{214} Id. at § 32.5(a)(1) (emphasis added).
\textsuperscript{216} 12 C.F.R. § 32.5(a)(2). On June 14, 1983, the effective date of the new lending limit regulations, the comptroller issued a minor amendment to the final regulations; see OCC, National Bank Lending Limits, Amendment to Final Rule, 48 Fed. Reg. 27,224 (1983), which also contains a discussion of the various comments received on the final regulations.
(B) One or more persons acting in concert control, in any manner, the election of a majority of the directors, trustees, or other persons exercising similar functions of another person; or

(C) Any other circumstances exist which indicate that one or more persons acting in concert directly or indirectly exercise a controlling influence over the management or policies of another person.\textsuperscript{217}

Substantial financial interdependence exists

(iii) \textit{[W]hen} 50 percent or more of one person's gross receipts or gross expenditures (on an annual basis) are derived from transactions with one or more persons related through common control . . . . Gross receipts and expenditures include gross revenues expenses, inter-company loans, dividends, capital contributions, and similar receipts or payments.\textsuperscript{218}

This 50\% test would not be applicable to unrelated parties (e.g., a manufacturer selling all its product to an unaffiliated retail chain). Because of the difficulty in determining "common control" and "substantial financial interdependence," a bank may wish to consider obtaining appropriate written representations on these matters in loan transactions which raise "common enterprise" concerns, or; "(iv) \textit{[I]f} separate persons borrow from a bank for the purpose of acquiring the business enterprise of which those persons own more than 50 percent of the voting securities."\textsuperscript{219} The Comptroller takes the position that the aggregation rules will be applied with flexibly. For example, the Comptroller \textit{may} be receptive to the substitution of a corporation for a partnership in a loan restructure for purposes of avoiding the lending limit aggregation rules. From a practical point of view, whether a common enterprise exists depends on a realistic evaluation of the facts and circumstances of a particular transaction.\textsuperscript{220}

\textsuperscript{217} 12 C.F.R. § 32.5(a)(2)(v).
\textsuperscript{218} Id. at § 32.5(a)(2).
\textsuperscript{219} Id at § 32.5(a)(2)(iv).
\textsuperscript{220} Id. at § 32.5(a)(2)(i).
The revised regulation provides greater flexibility for a national bank lending to corporate groups than the prior regulations. For example, no longer will loans made by a bank to a parent and to its subsidiary be automatically combined, unless a common enterprise exists. Under the revised rule: "Loans or extensions of credit to a person and its subsidiary or to subsidiaries of one person need not be combined where the bank has determined that the person and subsidiaries involved are not engaged in a 'common enterprise' . . . ." Notwithstanding the new flexibility, loans and extensions of credit to a "corporate group" are subject to an aggregate lending limit. The limit, which is not to exceed 50% of the bank's unimpaired capital and unimpaired surplus, applies whether or not a common enterprise exists among persons in the corporate group. A "corporate group" is defined to include a person (which term embraces an individual and partnership, as well as a corporation) and all of its subsidiaries; thus, an individual or a partnership can be a corporate parent. The term subsidiary means a corporation of which a "person" owns or beneficially owns more than 50% of the voting stock. By definition, a "corporate group" cannot exist among a person and controlled partnerships.

(c) The Rules for Partnerships

The rules concerning aggregation of partnership loans are based upon the premise that partnership loans are unique since each partner is jointly and severally liable for all partnership liabilities. The revised rules continue the prior approach as follows: "Loans or extensions of credit to a partnership, joint venture, or association shall . . . be considered

221. Id. at § 32.5(b)(2).
222. Id.
223. Id. at § 32.5(b)(3).
224. Id.
225. Id. at § 32.5(b)(1).
226. Id. at §§ 32.5(b)(1) & (3).
loans or extensions of credit to each member of such partnership, joint venture, or association."227 This rule can be explained by an example given by the Comptroller in the supplementary information to the revised regulation:

Thus, assuming that a bank's lending limit is $100,000, it may extend $50,000 of credit to A and B who are general partners of the partnership, AB, and it may also lend $50,000 to AB (the partnership). This is because AB's loans will be attributed individually to both A and B. If, however, B is also a member of partnership BC, which desires to borrow $50,000, the bank will be unable to make the loan to BC, since both AB's $50,000 loan and BC's $50,000 loan made would be attributed to B, who already has a $50,000 personal loan.228

The rule under the revised regulation affirms the position that, absent the existence of a "common enterprise," loans or extensions of credit to members of a partnership should not be attributed to the partnership.229

The existence of a common enterprise among two or more partnerships would most probably arise where two or more common general partners exercise a "controlling influence" over the management of each partnership and where such partnership businesses are interdependent or where there is a substantial financial interdependence among them.230

The partnership aggregation rules are not applicable to limited partners in a limited partnership or to members of a joint venture or association if such partners or members, by the terms of the partnership or membership agreement, are not to be held liable for all the debts or actions of the partnership, joint venture, or association and otherwise do not hold themselves out to third parties as general partners.231 Even where such a situation exits, the taking of a third-party guaranty from any such joint venturer or member would probably negate the requirement of effective limited liability. Moreover, limited partners and such other partners and members would

227. Id. at § 32.5(c)(1).
229. 12 C.F.R. § 32.5(c)(2).
230. Id. (emphasis added).
231. Id. at § 32.5(c)(3) (emphasis added).
be subject to aggregation rules if they came under one of the “common enterprise” tests.

(d) The Rule for Foreign Governments

The rule in the revised regulation reaffirms the Comptroller’s position that loans to government owned corporations are to be governed by the rules applicable to sovereign loans and retains the “means” and “purpose” test contained in the current regulations.\(^{232}\) Such loans would be combined only if they fail to meet either of the following tests at the time the loan or extension of credit is made: “(i) The borrower has resources or revenue of its own sufficient over time to service its debt obligations (i.e., ‘means test’); [or] (ii) The purpose of the loan or extension of credit is consistent with the purposes of the borrower’s general business (i.e., ‘purpose test’).”\(^{233}\) To demonstrate that the “means” and “purpose” tests have been satisfied, a bank must assemble and retain in its files prescribed documents, including: a statement describing the legal status and degree of financial and operational autonomy of the borrowing entity, three-year financial statements of the borrowing entity and financial statements for each year the loan or extension of credit is outstanding, the bank’s assessments of the borrower’s means of servicing the loan and the loan agreement or other written statement from the borrower clearly describing the purpose of the loan or extension of credit.\(^{234}\)

5. Statutory Exceptions to the Lending Limit

Loans and extensions of credit may exceed the general lending limit if they qualify under one of the ten statutory exceptions or other rules of exclusion set forth in the revised regulation. The following chart lists the statutory exceptions existing under revised 12 U.S.C. § 84 and the revised regulation.

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233. 12 C.F.R. § 32.5(d)(1)(i) & (ii).
234. Id. at § 32.5(d)(2)(i)-(v).
### 12 U.S.C. § 84 Exceptions

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Other transactions, while not excepted by statute from the lending limit, may be exempt from the lending limit by means of the Comptroller’s authority to promulgate lending limit regulations, or may be excepted because they are governed by other laws or regulations.

Negotiable and non-negotiable certificates of deposit issued by the lending bank qualify for exception (6). Other bank negotiable certificates of deposit do not qualify for the exception. Federal Home Loan Mortgage Corporation

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236. Id.
Participation Certificates (FHLMC guaranteed PCs) do not qualify for exception (4) or exception (5).\textsuperscript{237} Standby letters of credit issued by a bank to the benefit of the lending bank do not qualify under any of the lending limit exceptions and are not "readily marketable collateral" under the additional 10% of capital and surplus limit.\textsuperscript{238} The Comptroller has explored various options or automobile lease-note financing exceptions (8), in an interpretive letter.\textsuperscript{239}

6. Statutory Liability

The 1982 Banking Act does not change the liability imposed by the National Bank Act upon directors of a national bank for knowingly violating or knowingly permitting a bank officer or agent to violate any provision of such Act, including the lending limit provisions. Accordingly, a director who consents to or participates in an excessive loan is liable for damages suffered by the bank, its shareholders or other persons.\textsuperscript{240}

In addressing this question of director liability, there are three relevant issues: Is the obligation to the borrower in excess of the single borrower limitation? Did the director knowingly make or assent to the making of the loan? What portion of the loan proceeds were lost?

Mere negligence of a director for an excessive loan is probably not sufficient to incur liability under the statute. However, if a director deliberately refrains from investigating that which it was his duty to investigate, any resulting violation of the statute will be regarded as in effect intentional.\textsuperscript{241}

In addition to the statutory liability under the National Bank Act, directors of national banks have common law duties to exercise due care, prudence and undivided loyalties in

\textsuperscript{241} See Del Junco v. Conover, 682 F.2d 1338 (9th Cir. 1982), cert. denied, 459 U.S. 1146 (1983); but cf. Larimore v. Conover, 775 F.2d 890 (7th Cir. 1985), rev'd on reh'g en banc, 789 F.2d 1244 (7th Cir. 1986).
their role as directors of the bank.242 A right of contribution may exist among bank officers for a section 84 violation and award of damages.

7. Forbearance Rules

The Comptroller has recently enacted a rule providing a substitute, and more lenient, lending limit for national banks with charged-off agricultural and energy loans.243

B. Savings and Loan Associations

The FSLIC has ruled that with respect to a federally insured S&L (and any of its "service corporations") the "total balances" of all outstanding loans to "one borrower" must not exceed an amount equal to 10% of an institution's withdrawable accounts, or an amount equal to an institution's net worth, whichever amount is less.244 Effective January 1, 1984, an exception exists for any loan not exceeding $500,000 (subject to annual Consumer Price Index adjustments).245 In addition, the single borrower limit for commercial loans is the same as the limit for national banks under revised section 84.246 Calculation of aggregate limitations is geared to funds actually advanced (except for standby letters of credit) and guaranties or suretyship obligations.247

The term "one borrower," for purposes of the FSLIC limitation, includes the following:

Any person or entity that is, or that upon the making of the loan will become, the obligor on a loan . . . . Nominees of such obligor; [and] all persons, trusts, syndicates, partnerships, and corporations of which such obligor is a nominee, a beneficiary, a member, a general partner, a limited partner owning an interest of ten percent or more (based on value of

243. OCC, Comment on National Banks Lending Limits, 51 Fed. Reg. 15,303 (1986); see supra note 105.
244. 12 C.F.R. § 563.9-3(b)(1) (1986).
245. Id.
246. Id. at § 563.9-3(b)(2).
247. Id. at § 563.9-3(a)(2).
his contribution, or a record or beneficial stockholder owing ten percent or more of the capital stock [of such obligor].

In the case of a loan assumed by a third party with the consent of the lending insured institution, the former debtor will no longer be deemed an "obligor." In calculating its aggregate loans to "one borrower," an S&L must add the sum of: (i) the amount of the loan and, (ii) the "total balances" of all outstanding loans owed to the S&L and its affiliated service corporations by the borrower. Standby letters of credit and guaranties of suretyship obligations are treated as outstanding loans to the account party or principal, rather than loan suggestions.

The FHLBB has announced that, although federal thrift institutions and national banks are subject to the same unimpaired capital and unimpaired surplus limitations on commercial loans to one borrower, not all of the same national bank single borrower loan limitations will be applicable to such thrift institutions. Thrift institutions will be required to rely on FHLBB rules and interpretations in the event of a conflict with Comptroller regulations. For example, the FHLBB has its own definition of one borrower, and does not follow the Comptroller's attribution regulations.

C. Relationship to Underlying Contractual Commitment

A banking institution may not raise the statutory lending limitation as a defense to avoid or limit its underlying contractual limitations with a non-conspiring borrower.

248. Id. at § 563.9-3(a)(1)(i)(a)-(c).
249. Id. at § 563.9-3(a)(1)(ii).
V. FIRA Restrictions: Loans to "Insiders"

The Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) was enacted by Congress in response to abusive practices engaged in by bank insiders. These practices included; (i) loans to bank insiders that were excessive in amount or preferential as to terms, and/or that involved greater than normal risk, and (ii) receipt of preferential treatment by a bank insider because of his ability to control the distribution of correspondent banking business. Title IV, Part B of the 1982 Banking Act affected numerous amendments to the original FIRA provisions.

A. Introduction to FIRA

A primary objective of Titles I, VIII and IX of FIRA, as amended, is to limit preferential and excessive loans to bank insiders. To achieve this objective, FIRA imposes limitations on credit terms, aggregate lending limits, overdrafts and correspondent loans available to insiders. It also requires submission of public and regulatory reports.

The 1982 Banking Act eliminated dollar ceilings on home loans, educational loans and "other" loans subject to the banking authorities' limitations on such loans. The FRB, Comptroller and the FDIC have promulgated separate regulations implementing the amended FIRA restrictions. The FDIC regulation adopts its own definitions, does not limit borrowing by insiders, prohibits preferential lending involving correspondent banks and requires that insiders report borrowing from their banks and correspondent banks. The FRB

256. Section 421 of the 1982 Banking Act.
258. Id. at § 31.
259. Id. at § 349.
260. Id.
and Comptroller have adopted identical definitions and lending limits for bank insiders.\textsuperscript{261} All three banking authorities have adopted substantially similar reporting requirements.\textsuperscript{262}

Since FRB Regulation O is the most comprehensive in scope, it will be the primary discussion in the ensuing sections. It should be noted that Regulation O applies to all FRS member banks (state and national), except to the extent the FIRA statutory provisions expressly permit another bank regulator to promulgate regulations on a particular matter. Thus, for example, with respect to national banks, one must carefully read and interrelate the FIRA provisions, with Regulation O and with the Comptroller’s FIRA regulation. It should also be noted that, while the practice of the FRB is to repeat in its regulation statutory requirements, the Comptroller does not if the statutory language is clear and binding. As such, while the Comptroller’s regulation appears abbreviated, it is essentially coextensive in coverage and treatment with Regulation O.

\textbf{B. Key Definitions}

The following definitions are essential to an understanding of the FIRA restrictions on “insider” loan transactions.

1. Executive Officers

This term includes persons who have authority to participate in “major policymaking functions” whether or not (i) the officer has an official title, (ii) the title designates the officer as an assistant, or (iii) the officer serves without compensation.\textsuperscript{263} There is no definition of “major policy making functions.” However, the FRB regulations provide that the phrase does not include mere discretion in the granting of loans or discretion limited by policy standards fixed by senior management of the bank or the company. For example, a manager of a

\textsuperscript{261} Id. at §§ 215.2, 31.3.
\textsuperscript{262} Id. at §§ 215.23 (FRB), 31.5 & .6 (Comptroller), 349.4 (FDIC).
\textsuperscript{263} Id. at § 215.2(d).
branch generally is not authorized to participate in major policy making functions but may exercise discretion in the performance of his duties.264

Generally, executive officers of the bank's parent holding company or subsidiaries of the holding company are deemed to be executive officers of the bank.265 The chairman of the board, the president, every vice president, the cashier and the treasurer of a bank or affiliated company are considered executive officers unless the officer is excluded by resolution of the board of directors or by the bylaws from participating in major policymaking functions, and the officer actually does not participate therein.266 It should be noted, however, that "executive officer" does not include an executive officer of the bank holding company for purposes of the specific restriction contained in 12 C.F.R. §§ 215.5, 215.8 and 215.9. As a practical matter, a bank's board of directors will eliminate, by resolution, those bank officers not considered to be in a "major policymaking" position, although the regulators will still look to substance over form.267

2. Directors

This term includes bank directors, holding company directors and other holding company subsidiary directors.268 An advisory director not elected by shareholder vote, not authorized to vote and not providing more than general policy advice is not included within the definition.269

3. Principal Shareholders

This term includes persons who own, control or have the power to vote more than 10% of the bank's outstanding stock.270

264. Id. at n.1.
265. Id.
266. Id. It should be noted, however, that "executive officer" does not include an executive officer of the bank holding company for purposes of the specific restriction contained in 12 C.F.R. §§ 215.5, .8 & .9.
267. Id.
268. Id. at § 215.2(c).
269. Id.
270. Id. at § 215.2(j).
4. Related Interests

This term includes (i) any company controlled by a bank insider, (ii) a political or campaign committee controlled by a bank insider or (iii) the funds or services of a political or campaign committee that will benefit a bank insider.\textsuperscript{271}

5. Correspondent Bank

This term covers a bank that maintains one or more correspondent accounts for an FRS member bank during a calendar year that exceed, in the aggregate, an average daily balance during that year of $100,000, or 5% of the member bank’s total deposits, whichever amount is smaller.\textsuperscript{272}

6. Correspondent Account

The term correspondent account covers an account maintained by a bank with another member bank for the deposit or placement of funds.\textsuperscript{273} It does not include: (i) time deposits at prevailing market rates and (ii) an account maintained in the ordinary course of business solely for the purpose of affecting federal funds transactions at prevailing market rates, or for the purpose of making eurodollar placements at prevailing market rates.\textsuperscript{274}

C. Insider Loans: General Prohibitions

Under FIRA, certain prohibitions pertain to extensions of credit to insiders of FRS member banks. These provisions include: preferential loans, prior approval, overdrafts and aggregate lending limits.

1. Preferential Loans

Under all circumstances, credit may be extended to an insider only if: (i) the bank would be authorized to extend credit to borrowers other than the insider, (ii) the terms are not more favorable than those given to other borrowers, (iii)

\textsuperscript{271} Id. at § 215.2(k).
\textsuperscript{272} Id. at § 215.21(d).
\textsuperscript{273} Id. at § 215.21(c).
\textsuperscript{274} Id.
the officer has submitted a detailed current financial statement and (iv) it is payable on demand if the officer is indebted to any other banks in an amount greater than the amount of credit that could be extended to him at his bank.\textsuperscript{275}

2. Prior Approval

Extensions of credit to a bank's executive officers, directors or principal shareholders or to any related interest of that person, that exceeds the higher of $25,000 or 5\% of the bank's capital and surplus, must receive prior approval of a majority of the board of directors of the bank.\textsuperscript{276} The interested party may not participate in the voting.\textsuperscript{277} Any participation in the discussion of, or any attempt to influence the voting by the board of directors regarding extension of credit, constitutes participation in the vote.\textsuperscript{278} Formal corporate action of the entire board is probably required, as the statute and regulation refer to the voting processes of the board.\textsuperscript{279} However, if the extension of credit is made pursuant to a line of credit approved within fourteen months of the date of the extension, no further approval is required.\textsuperscript{280} In addition, regardless of the size of the bank, all permitted loans to insiders that exceed $500,000 require the prior board approval.\textsuperscript{281}

3. Overdrafts

An extension of credit in the form of an overdraft to a bank executive officer or director may not be paid by a FRS member bank unless there is a written, preauthorized, interest-bearing, extension-of-credit plan that specifies a method of prepayment or unless there is a written preauthorized transfer of funds from another account.\textsuperscript{282} There is an exception to this rule for inadvertent overdrafts of $1,000 or less

\begin{itemize}
\item \textsuperscript{275} 12 U.S.C. § 375(a)(1) (1986).
\item \textsuperscript{276} 12 C.F.R. § 215.4(b).
\item \textsuperscript{277} \textit{Id}.
\item \textsuperscript{278} \textit{Id}.
\item \textsuperscript{279} \textit{Id}.
\item \textsuperscript{280} \textit{Id.} at § 215.4(b)(2).
\item \textsuperscript{281} \textit{Id}.
\item \textsuperscript{282} \textit{Id.} at § 215.4(d).
\end{itemize}
not overdrawn for more than five business days.\textsuperscript{283} Under this exception, the insider must be charged the same fee charged to other customers.\textsuperscript{284}

4. Aggregate Lending Limit

Extensions of credit to a bank executive officer, principal shareholder or a related interest of that person are subject to an aggregate lending limit.\textsuperscript{285} This limit is analogous to, but more comprehensive than, the single borrower limitation provided by 12 U.S.C. § 84. For example, the borrowing of an executive will be aggregated automatically with the borrowing of a "related interest." This limitation does not apply to directors, unless they are also executive officers or principal shareholders.\textsuperscript{286}

D. Loans to Executive Officers — Specific Restrictions

FIRA amends 12 U.S.C § 375a regarding specific restrictions on loans to executive officers.

1. General Purpose Loans

An FRS member bank may extend credit to its executive officers, for purposes other than residential or educational loans, in a dollar amount prescribed under regulation by the member bank's appropriate federal banking agency.\textsuperscript{287} Regulation O presently provides a limit of the higher of $21/2\% of the bank's capital and unimpaired surplus or $25,000, but in no event more than $100,000.\textsuperscript{288} Loans to an executive officer (not to exceed the foregoing limits) and to his "related interests" cannot exceed $500,000 in aggregate without prior board of directors' approval and (in all events) these aggregated loans cannot exceed the institution's single borrower lending

\textsuperscript{283} Id.

\textsuperscript{284} Id.

\textsuperscript{285} Id. at § 215.4(c). For consideration of the lending limit under 12 U.S.C. § 84, see supra text accompanying notes 164-252.

\textsuperscript{286} 12 C.F.R. § 215.4(c).


\textsuperscript{288} 12 C.F.R. § 215.5(c)(3).
limit.\textsuperscript{289} Notwithstanding the foregoing, however, the narrower $100,000 rule applies to a partnership, in which one or more of the bank's executive officers are partners with a majority interest, either individually or collectively. The full amount of the loan to the partnership is, in effect, deemed to be a direct loan to each involved executive officer.\textsuperscript{290} Notwithstanding the foregoing clarification, the limits also apply generally to the extension of credit to the partnership.\textsuperscript{291}

2. First Mortgage Loans

Under section 421(a) of the 1982 Banking Act, a bank may make a loan, without limit, to finance the residence of an executive officer.\textsuperscript{292}

3. Educational Loans

Under section 421(a) of the 1982 Banking Act, no specific restrictions now exist on educational loans.\textsuperscript{293}

E. Transactions With Correspondent Banks

Title VIII of FIRA limits lending transactions between a bank's insiders and their related interests and correspondent banks. FIRA, amendments to the BHCA prohibit: (i) the extension of preferential loans by a bank to officers, principal shareholders, and directors and their related interests of a correspondent bank, and (ii) the initiation of a correspondent relationship with a bank, if that bank has extended preferential credit to the initiating bank's principal shareholders, executive officers or directors and their related interests.\textsuperscript{294} Section 428 of the 1982 Banking Act makes various amendments to the correspondent banking provisions of FIRA, principally by

\textsuperscript{289} Id. at § 215.4(b)(1) & (c).
\textsuperscript{290} Id. at § 215.5(b).
\textsuperscript{291} Id. An FRB member bank may lend an amount equal to 2.5\% of its capital and unimpaired surplus or $100,000, whichever is lower, to a partnership in which one or more of its executive officers has a majority interest. Id. at § 215.5(c)(3).
\textsuperscript{292} 12 U.S.C. § 375a(g)(2)(A); 12 C.F.R. §§ 215.5(b), (c)(2) & (3).
\textsuperscript{293} 12 U.S.C. § 375a(3); 12 C.F.R. § 215.5(c)(1).
\textsuperscript{294} 12 U.S.C. § 1972(2)(A), (B) & (D); 12 C.F.R. § 215.20.
extending such restrictions on preferential insider loans to include loans to "related interests" and by conferring rulemaking authority on the appropriate federal banking agencies.

Although the term "preferential lending" is not defined, the statute provides that any lending relationship or extension of credit must be on "substantially the same terms, including interest rates and collateral as those prevailing at the time for comparable transactions with other persons and does not involve more than the normal risk of repayment . . . ."\textsuperscript{295}

In summary, the basic purpose of these correspondent account provisions is to prevent banks that maintain correspondent accounts with other banks and the banks with which these accounts are maintained from making extensions of credit on a preferential basis to each other's executive officers, directors or principal shareholders and their related interests.

\section*{F. Reporting Requirements}

The amendments to the Federal Deposit Insurance Act and the BHCA, FIRA and the 1982 Banking Act provide for a reporting system for insider loan transactions. The banking authorities have promulgated a uniform system of reporting concerning loans to bank insiders. In addition all banking authorities have promulgated regulations requiring public disclosure, upon request, of the names of insiders and their related interests from their own banks or correspondent banks that equaled or exceeded 5\% of the reporting bank's capital or $500,000, whichever is less.\textsuperscript{296}

\section*{G. Penalties}

FIRA imposes civil penalties on a director, executive officer, bank or other party (such as an aider or abettor) which is subject to, and which violates, provisions governing extension of credit to insiders.\textsuperscript{297} These penalties may include a fine of up to $1,000 per day for the continuation of the violation.\textsuperscript{298}

\begin{footnotes}
\item 296. Id. at §§ 1817(k)(1), 1972(G)(iii); 12 C.F.R. § 215.23.
\item 298. 12 C.F.R. § 215.11.
\end{footnotes}
Treble damages may also be imposed for the violation of certain correspondent loan provisions. The violator may also be liable to the injured party for the cost of the law suit, including attorney's fees. Section 424 of the 1982 Banking Act now provides the appropriate federal banking authority with broad discretionary powers in compromising, modifying or remitting any civil money penalty imposed under FIRA and its implementing regulations. Bank officers and directors may also be subject to criminal prosecution if they willfully misapply funds of their bank. Finally, bank officers and directors may be suspended or removed from office for violating banking laws or obtaining financial gain at the expense of the bank.

VI. LOANS TO "AFFILIATES"

Federal banking laws restrict extensions of credit to special parties, such as "affiliates."

A. Generally Respecting Special Borrowers

There are restrictions on banking institutions regarding loans to, and investments in, specified individuals and entities, including: bank examiners, as to whom there is generally an absolute prohibition; loans to insiders, and loans to affiliates, as to which there are severe limitations under FIRA, as amended.
B. Affiliates

Section 410 of the 1982 Banking Act amends Section 23A of the Federal Reserve Act. The amendment, which is applicable to FDIC insured banks, liberalizes certain restrictions on transactions with affiliates, closes certain loopholes and reorganizes and clarifies the statute.

1. The Definition of Affiliates

An "affiliate" includes: (i) a company that controls the bank; (ii) a company that is controlled by the company that controls the bank; (iii) a bank subsidiary of the bank; (iv) a company controlled by shareholders who also control the bank or its holding company; (v) a company in which a majority of directors also constitutes a majority of the directors of the bank or its holding company; (vi) an investment company for which the bank or its affiliates is an investment advisor; (vii) a company, including a real estate investment trust, sponsored and advised by the bank or (viii) a company deemed by the FRB to be an affiliate. 309

Section 371c of the 1982 Banking Act defines "control" as the power: (a) to vote 25% or more of the voting shares of a company, excluding situations in which the stock is controlled in a fiduciary capacity, or (b) to elect a majority of the directors of a company. This definition recognizes that effective control can be exercised only by a majority of the directors of a company, but often may be exercised by shareholders holding less than a majority of the voting shares. 310 In the case of an interlocking relationship, this translates into any situation in which: (a) a group of shareholders controls 25% or more of the shares of both a banking organization and a company, or (b) a majority of the directors of a banking organization also constitutes a majority of the directors of a company. 311

A company is defined as an "affiliate" by virtue of a trust arrangement whenever trustees control 25% or more of the voting shares of a company (banking organization) for the

310. Id. § 371c(b)(3)(A).
311. Id.
benefit of shareholders who control 25% or more of the voting shares of a banking organization (company).\textsuperscript{312} In addition, the FRB may determine that a company or shareholder exercises a controlling influence over the management or policies of the other company, and deem the company to be an affiliate.\textsuperscript{313}

2. Affiliates Exempt from Coverage

Certain entities are not considered affiliates of FDIC insured banks. These include: (i) a company, other than a bank, that is a subsidiary of the bank; (ii) a company engaged solely in holding the premises of the bank; (iii) a company engaged solely in conducting a safe deposit business; (iv) a company that holds United States obligations and (v) a company affiliated as a result of a foreclosed loan.\textsuperscript{314}

Section 371c excludes only majority owned subsidiaries from the definition of “affiliates.”\textsuperscript{315} In addition, the Board of Governors of the FRS may define as an affiliate any company of which a bank owns 25% or more, if transactions with that company could have adverse effects on the bank.\textsuperscript{316}

Other entities excluded from the definition of affiliates include 80% or more owned sister banks or 80% or more owned subsidiary banks within a bank holding company for all purposes except (in a qualified manner) the restriction on the purchase of low quality assets.\textsuperscript{317} This treatment of multibank holding companies and the so-called chain banking vehicle recognizes the similarity of these types of organizations to branch banking. The minimum 80% ownership rule is intended to protect minority shareholders in banks less than 80% owned. The Comptroller recently ruled that a loan from a national bank to the trustee of an employee stock ownership

\begin{itemize}
\item \textsuperscript{312} Id. at § 371c(b)(1)(C) & (b)(3)(A).
\item \textsuperscript{313} Id. at § 371c(b)(3)(A)(iii).
\item \textsuperscript{314} Id. at § 371c(b)(2).
\item \textsuperscript{315} Id. at § 371c(b)(4).
\item \textsuperscript{316} Id. at § 371c(b)(1)(E).
\item \textsuperscript{317} Id. at § 371c(d)(1); see infra text accompanying notes 320-23.
\end{itemize}
plan would not be subject to 12 U.S.C. § 371c because the trustee is not an affiliate as defined by 12 U.S.C. § 221a.318

3. Transactions Included in Section 371c

The following transactions are included as "covered transactions" within the restrictions of section 371c: (i) a loan or extension of credit to an affiliate; (ii) purchase of, or investment in, securities of an affiliate; (iii) purchase of assets of an affiliate, including assets subject to a repurchase agreement; (iv) use of securities issued by an affiliate as collateral security for a loan to any person or company or (v) issuance of a guarantee, acceptance, or letter of credit, including endorsement or standby letters of credit, on behalf of an affiliate.319 Any transaction, the proceeds of which are used for the benefit of, or transferred to, an affiliate constitutes a transaction with an affiliate.

4. Special Treatment of the Purchase of Low Quality Assets

Generally, an FDIC insured bank and its subsidiaries may not purchase low quality assets from an affiliate. The term "low quality asset" is an asset: (i) classified as "substandard," "doubtful," or "loss," or treated as "other loans especially mentioned" in the most recent report of examination or inspection of an affiliate prepared by a federal or state examiner; (ii) in a nonaccrual status; (iii) on which principal or interest payments are more than thirty days past due or (iv) for which terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor.320

A qualification to the general prohibition has been granted to commonly owned banks. The purchase of low quality assets by 80% owned sister banks or banks that are 80% owned by a holding company is permissible, provided that the

320. Id. at § 371c(b)(10).
purchase is consistent with safe and sound banking practice.\textsuperscript{321} Whether the purchase of a low quality asset is a safe and sound banking practice is determined by the purchasing bank's primary federal supervisor. Recent consultation with the federal banking supervisors disclosed that no formal policy has been taken on this issue.

Section 371c sets forth another exception to low quality asset prohibition unrelated to common ownership between banks. This exception permits the purchase of low quality assets from an affiliate if the purchase is pursuant to an independent credit evaluation, committed to by the bank prior to the time the asset is acquired by the affiliate.\textsuperscript{322}

The history of the exception is explanatory. In 1974, the Board of Governors of the FRS issued a significant interpretation addressing the issue of whether a bank's purchase of a note from a mortgage banking affiliate was an extension of credit to an affiliate. The Board concluded that the purchase of mortgage notes, or participations in mortgage notes, constituted a loan or extension of credit to the affiliate, subject to the limitations of section 371c. However, there would be no extension of credit to the affiliate if the bank's commitment to purchase the loan or participation was obtained by the affiliate in anticipation of the affiliate's commitment to make the loan, and the purchase was based upon the bank's independent evaluation of the creditworthiness of the mortgagor.\textsuperscript{323}

The distinction between these two events is that the latter circumstance evidences taking advantage of an investment opportunity by the bank. The former circumstance evidences action taken under the improper incentive to alleviate working capital needs of the affiliate directly attributable to excessive outstanding commitments. This interpretation applies to mortgage loans, promissory notes, bills of exchange, conditional sales contracts and similar paper. The principles of this interpretation are now codified in section 371c and are made explicitly applicable to low quality assets.

\textsuperscript{321} Id. at § 371c(a)(4) & (d)(1).
\textsuperscript{322} Id. at § 371c(a)(3).
\textsuperscript{323} Id. at § 371c(c)(4).
5. Collateral Requirements

The 1982 Banking Act also revises the collateral requirements for loans, extensions of credit, guarantees, acceptances or letters of credit issued on behalf of an affiliate by a bank or its subsidiaries. Collateral securing such transactions must have a market value equal to: (i) 100% of the transaction if the collateral consists of: U.S. obligations or U.S. guaranteed obligations, instruments eligible for rediscount or purchase at a Federal Reserve Bank or segregated, earmarked deposit accounts with the lending bank;\(^324\) (ii) 110% of the amount of the transaction if the collateral consists of state obligations;\(^325\) (iii) 120% of the amount of the transaction if the collateral consists of debt instruments, including receivables\(^326\) or (iv) 130% of the amount of the transaction if the collateral is stock, leases, or other real or personal property.\(^327\)

The initial ratio between the transaction and the collateral must be maintained during the term of the transaction.\(^328\) As the outstanding balance of the transaction increases or decreases, the collateral must be adjusted.\(^329\) The collateral must be replaced entirely with other eligible collateral if the initial collateral is retired or amortized.\(^330\)

These collateral requirements do not apply to an acceptance secured by attached documents or by other property having an ascertainable market value involved in the transaction.\(^331\) Low quality assets or securities issued by an affiliate of the lending bank are not acceptable as collateral.\(^332\)

6. Quantitative Limitations

Section 371c limits the aggregate amount of "covered transactions" between the bank and its subsidiaries and any one affiliate to 10% of the bank's capital and surplus. It limits

\(^324\) Id. at § 371c(c)(1)(A).
\(^325\) Id. at § 371c(c)(1)(B).
\(^326\) Id. at § 371c(c)(1)(C).
\(^327\) Id. at § 371c(c)(1)(D).
\(^328\) Id. at § 371c(c)(2).
\(^329\) Id.
\(^330\) Id.,
\(^331\) Id. at § 371c(c)(5).
\(^332\) Id. at § 371c(c)(3).
covered transactions between a bank and all of its affiliates to 20% of the bank's capital and surplus.\textsuperscript{333} The aggregate amount of "covered transactions" is the amount of the covered transactions about to be engaged in, plus the amount of all outstanding covered transactions.\textsuperscript{334}

7. Exempt Transactions

Transactions exempt from the limitations of section 371c include: (i) making deposits in an affiliated bank in the ordinary course of correspondent business;\textsuperscript{335} (ii) giving immediate credit to an affiliate for uncollected items received in the ordinary course of business;\textsuperscript{336} (iii) making a loan or extension of credit to, or issuing a guarantee, acceptance, or letter of credit on behalf of, an affiliate that is secured by obligations of the United States or a segregated, earmarked deposit with the national bank;\textsuperscript{337} (iv) purchasing securities issued by any company of the kinds described in section 1843(c)(1) of Title 12;\textsuperscript{338} (v) purchasing assets having a readily identifiable and publicly available market quotation and purchased at the market quotation, or purchasing loans on a nonrecourse basis from affiliated banks\textsuperscript{339} and (vi) purchasing from an affiliate a loan or extension of credit that was originated by the national bank and sold to the affiliate subject to a repurchase agreement or with recourse.\textsuperscript{340}

VII. OTHER FEDERAL BANKING LAW CONSIDERATIONS

A commercial loan may involve a number of special banking law considerations including anti-tying, securities credit, loan participation, currency transaction reporting, bribery, RICO and criminal concerns.

\textsuperscript{333} Id. at § 371c(a)(1)(A).
\textsuperscript{334} Id. at § 371c(a)(1)(B).
\textsuperscript{335} Id. at § 371c(b)(8).
\textsuperscript{336} Id. at § 371c(d)(2).
\textsuperscript{337} Id. at § 371c(d)(3).
\textsuperscript{338} Id. at § 371c(d)(4).
\textsuperscript{339} Id. at § 371c(d)(5).
\textsuperscript{340} Id. at § 371c(d)(6).
A. Bank Antitrust Law and Tying Arrangements

Federal statute prohibits national and state banks from "tying" an extension of credit to the compliance of a bank customer with the following conditions: (i) obtaining additional credit, property or service from the bank (other than a loan, discount, deposit, or trust service); (ii) obtaining additional credit, property or service from a bank holding company or subsidiary of a bank holding company of the bank; (iii) providing additional credit, property or service to the bank other than those related to, and usually provided in connection with, a loan, discount, deposit or trust service; (iv) providing additional credit, property, or services to a bank holding company or subsidiary of a bank holding company of the bank or (v) prohibiting the customer from obtaining other credit, property, or service from a competitor, or a holding company or subsidiary of a bank holding company of the competitor other than requirements reasonably imposed in a credit transaction to assure the soundness of the credit.\(^{341}\)

One state supreme court has held that, unless anticompetitive effects can be shown, a bank did not violate prohibitions against tying arrangements by requiring a third party to provide a mortgage on a previously unsecured loan before the bank extends credit to another (affiliated) party.\(^{342}\) The requirement that franchisees deposit receipts in a franchisor's name at a franchisor approved bank does not constitute an illegal tying arrangement since the deposits were not products tied to the purchase of the franchise.\(^{343}\) Also, requiring a borrower to obtain related loan service from a list of third parties approved by the lender is not an anti-tying violation.\(^{344}\)

A non-customer of the bank does not necessarily lack standing under the bank tying statutes, although problems of lack of standing for "remoteness" may arise.\(^{345}\) The 1982 Banking Act applies anti-tying restrictions to federal S&Ls in a manner similar to the above anti-tying provisions applicable

\(^{341}\) Id. at § 1972(1).
\(^{343}\) See Parsons Steel, Inc. v. First Ala. Bank, 689 F.2d 242 (11th Cir. 1982).
\(^{344}\) See Bender v. Southland Corp., 749 F.2d 1205 (6th Cir. 1984).
\(^{345}\) See Campbell v. Wells Fargo Bank, 781 F.2d 440 (5th Cir. 1986).
to banks and bank holding companies under the Bank Holding Company Act of 1956, as amended.\footnote{346}

\section*{B. Securities (Margin) Credit and Federal Reserve Board Regulation U (including "Junk Bond" Regulation)}

FRB Regulation U, promulgated under the Federal Securities Exchange Act of 1934,\footnote{347} restricts the amount of "margin stock" secured credit that a bank may extend for the purpose of purchasing or carrying margin stock to a specific percentage (50\%).\footnote{348} On July 27, 1983, the FRB promulgated substantially revised and simplified margin rules under Regulation U,\footnote{349} and technical amendments thereto.\footnote{350} The FRB has published a comparison chart on Regulation U.\footnote{351}

A bank need not file a Form U-1 simply because a credit is directly or indirectly secured by any stock. A bank now must file this form and comply with the margin stock percentage requirement, as related to the value of such collateral, only where the credit is directly or indirectly secured by margin stock.\footnote{352} The revised regulation now applies to both member and nonmember FRS banks that extend credit for the purpose of purchasing or arranging securities, but (as before) not to S&Ls and credit unions.\footnote{353} There appears to be no private right of action under Regulation U.\footnote{354}

Margin stock for purposes of Regulation U includes:

\begin{itemize}
  \item [(1)] Any equity security registered or having unlisted trading privileges on a national securities exchange;
  \item [(2)] any OTC margin stock;
\end{itemize}

\begin{itemize}
  \item [346.] Cf. McGee v. First Fed. Sav. & Loan Ass'n, 761 F.2d 647 (11th Cir. 1985).
  \item [348.] See id. at § 78g; 12 C.F.R. § 221 (1986).
  \item [349.] 12 C.F.R. § 221.3(a).
  \item [353.] 12 C.F.R. §§ 221.3(a), (c) & 221.4.
  \item [354.] Id. at § 221.2(b).
\end{itemize}
(3) any OTC security designated as qualified for trading in the National Market System under a designation plan approved by the Securities and Exchange Commission (NMS security).

(4) any debt security convertible into a margin stock or carrying a warrant or right to subscribe to or purchase a margin stock;

(5) any warrant or right to subscribe to or purchase a margin stock; or

(6) any security issued by an investment company registered under Section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), other than:

(i) a company licensed under the Small Business Investment Company Act of 1958, as amended (15 U.S.C. 661); or

(ii) a company which has at least 95 percent of its assets continuously invested in exempted securities

Regulation U is particularly important where the purpose of the commercial loan is to finance an acquisition involving margin stock, or where the restrictive nature of covenants contained in the commercial loan agreement effectively make the loan “indirectly secured” by margin stock.\(^{355}\)

On January 8, 1986, and in response to the rash of hostile takeovers financed by “junk bonds,” a divided FRB adopted an interpretative ruling to its Regulation G (a margin rule similar to Regulation U but applying to lenders other than banks and broker-dealers). This ruling concludes that debt securities issued by a shell corporation with no assets of its own, for the purpose of acquiring stock in a large entity, are considered “indirectly secured” by “margin” stock. As such these securities would be subject to the 50% margin limitations, subject to three exclusions: (i) operating companies with substantial assets or cash flow; (ii) guarantees of borrowing by

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\(^{355}\) Id. at § 221.2(h)(1)-(6); Bassler v. Central Nat’l Bank, 715 F.2d 308 (7th Cir. 1983).

companies with substantial assets or cash flow agreed-upon mergers and (iii) statutory "short-form" mergers where the acquiring party already has a substantial ownership interest in the target. 357

C. Loan Participations

In addition to lending limit and securities law implications respecting loan participations, it is also worth noting for this present topic the Comptroller's recent position on loan participations. Inspired by the substantial problems of Continental Illinois National Bank and Trust Company, the Comptroller has revised its policies concerning loan participation, whereby in part a purchasing bank is required to perform its own independent credit analysis. This policy also encourages written lending policies and procedures by banks, agreement by the borrower to provide full credit information to the bank making the loan, agreement by the selling bank to provide full credit information to the purchasing bank and written documentation of any recourse arrangements, setting forth the rights and obligations of each party. 358

D. Limitations on Standby Letter of Credit

Traditionally, letters of credit are indispensable instruments in international commercial transactions, serving as a finance and payment mechanism in the sale of goods. In recent years, the letter of credit, in the form of the standby letter of credit (SLC) has served a different function, by directing the issuer to pay the beneficiary not in the event of performance but upon the customer's default or nonperformance. The SLC provides security for the customer's performance, with no one initially expecting the beneficiary to draw


upon the credit, although legally the SLC is an absolute obligation of the issuing bank. As such, the SLC has functional attributes of both an unsecured loan and a guaranty.  

The state, federal, contractual and international legal implications of the SLC are outside the scope of this article. However, it should be noted here that with respect to national banks the Comptroller provides:

A national bank may issue letters of credit permissible under the Uniform Commercial Code or the Uniform Customs and Practice for Documentary Credits to or on behalf of its customers. As a matter of sound banking practice, letters of credit should be issued in conformity with the following: (a) each letter of credit should conspicuously state that it is a letter of credit or be conspicuously entitled as such; (b) the bank's undertaking should contain a specified expiration date or be for a definite term; (c) the bank's undertaking should be limited in amount; (d) the bank's obligation to pay should arise only upon the presentation of a draft or other documents as specified in the letter of credit, and the bank must not be called upon to determine questions of fact or law at issue between the account party and the beneficiary; (e) the bank's customer should have an unqualified obligation to reimburse the bank for payments made under the letter of credit.

The Comptroller has taken the position that this ruling applies to "commercial" letters of credit and not to SLCs. While setting no formal standards for SLCs, the Comptroller has ruled that for purposes of the lending limit rule of 12 U.S.C. § 84, SLCs are included, except if:

prior to or at the time of issuance, the issuing bank is paid an amount equal to the bank’s maximum liability under the standby letter of credit; or
prior to or at the time of issuance, the issuing bank has set aside sufficient funds in a segregated deposit account, clearly ear-marked for that purpose, to cover the bank’s maximum liability under the standby letter of credit; or

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the Comptroller of the Currency has found that a particular
standby letter of credit will not expose the issuer to the sim-
ilar risk of loss as would a loan to the account party.361

This ruling arose because of a major bank failure in 1973. The
FRB362 and the FDIC363 adopted comparable rules.

A long-standing legal issue is whether the SLC can be
characterized as a "guaranty," in which case the issuance
would be an ultra vires act of a national bank. In this respect,
the lines of definition are often blurred. However, the Comptrolder implicitly recognizes the authority of a national bank
to issue SLCs.364

In a private opinion letter by then Comptroller Chief
Counsel Brian Smith (dated July 28, 1983), it was concluded
that a bank (assuming it has made an independent and prior
credit evaluation) may issue standby letters of credit on be-
half of third party borrowers of the bank's parent holding
company. The holding company is designated as the benefi-
ciary of the letter of credit.

It should be noted that a bank's issuance of letters of
credit is subject to the antiboycott provisions of the Export
Administration Act, discussed. Failure to comply with these
restrictions may result in substantial liability for a bank.

The United States Court of Appeals for the Tenth Circuit
recently held, and was subsequently reversed by the Supreme
Court,365 that standby letters of credit are deposits for FDIC
insurance purposes, based on interpretation of FDIC Act defi-
nitions.366 If this were finally ruled to be the case, then FDIC
insurance premiums would be attributable to SLCs, thus af-
flecting their pricing. However, as mentioned, the Supreme
Court has overturned the circuit court.

361. For further discussion of letter of credit, see, e.g., Rendell, Standby Letter
of Credit, in Norton-CLG, supra note 3, at ch. 20.
363. Id. at § 208.3.
364. Id. at § 337.2 (1986).
365. See Philadelphia Gear Corp. v. FDIC, 751 F.2d 1131 (10th Cir. 1984), rev'd,
E. Bank Secrecy Act

The Bank Secrecy Act, enacted in 1970, requires financial institutions, federally insured banks and savings and loan associations, to maintain certain records and submit reports to the federal government to assist the federal government in its investigation of income tax evasion and criminal activity.\(^{367}\) The act requires or authorizes the Secretary of the Treasury to promulgate various types of reporting or recording regulations. The Secretary must require a United States citizen, resident or person present in the United States to record or report relationships with foreign financial agencies.\(^{368}\) The Secretary may promulgate regulations pertaining to "persons who transport currency or monetary instruments between the United States and a foreign country in an amount greater than $5,000;\(^{369}\) domestic and foreign currency or monetary instruments;\(^{370}\) and reproduction of instruments drawn on a financial institution and the identity of account holder."\(^{371}\)

Bank record keeping instruments basically fall within two categories. Account holder records mandate identification of account holders, with limited exceptions, by means of taxpayer identification numbers. The second category of records constitutes reproduction of checks, drafts or money orders drawn on a financial institution or issued and payable by it.\(^{372}\) Other records in this category include a wide variety of documents, the most important of which focus on items in excess of $10,000 and loan documents.\(^{373}\)

The Secretary of the Treasury may impose civil money penalties for violation of the act or may cause unreported imported or exported monetary instruments to be forfeited.\(^{374}\) The Secretary may enjoin parties for noncompliance through


\(^{372}\) 31 C.F.R. § 103.34 (1986).

\(^{373}\) Id. at §§ 103.34 & .36. See also United States v. Thompson, 603 F.2d 1200 (5th Cir. 1979).

the court of appropriate jurisdiction or may bring suit for criminal penalties.\textsuperscript{375} The Secretary may delegate enforcement of the act to a financial institution's primary bank regulator which may employ its administrative remedies to enforce the act.\textsuperscript{376}

\textbf{F. Comprehensive Crime Control Act of 1984}

The Comprehensive Crime Control Act of 1984 creates a revised bank bribery statute.\textsuperscript{377} The statute makes it a felony for a person associated with a financial institution, including a bank, savings and loan association or credit union or a holding company thereof, to accept anything of value from any person or entity in connection with any transaction or business related to the financial institution or holding company of which he is associated. Transactions include not only loan transactions but any transaction related to financial institution business. The statute prohibits any person from directly or indirectly giving, offering or promising anything of value to an official of a financial institution or a holding company in connection with any business of the financial institution: This provision covers the payer as well as the receiver of any bribe.

\textbf{1. Elements}

There are three basic elements of the bribery offense prescribed by this statute: (i) an act of soliciting or receiving a thing of value by an officer or employee of a financial institution or holding company for himself or a third party, (ii) done knowingly and willfully and (iii) with knowledge by the officer or employee that the act of soliciting or receiving was for or in connection with a transaction or business of a financial institution. These elements must be proved relative to a bribe received by a bank officer or employee.\textsuperscript{378}

To an individual offerer or payer under this statute, the elements are: (i) an act of offering or giving a thing of value to an officer or employee of a financial institution or holding

\textsuperscript{375} Id. at §§ 1954, 1956 & 1957.
\textsuperscript{376} Id. at § 1958.
\textsuperscript{378} 18 U.S.C. § 215(a).
company or its holding company for the benefit of either the officer or employee himself or a third party, (ii) an act of offering or giving done knowingly and willfully and (iii) knowledge that the act of offering or giving was for or in connection with a transaction or business of a financial institution.\textsuperscript{379}

2. Penalties

If the item offered or given is greater than $100 in value, the offense is a felony punishable by up to five years imprisonment and/or a fine of $5,000, or three times the value of the bribe or gratuity, whichever is greater. If the thing of value is $100 or less, the offense is a misdemeanor punishable by imprisonment of up to one year and/or a fine of $1,000. A higher fine, however, may be imposed for offenses committed after December 31, 1984.\textsuperscript{380} Under the act, an individual may be fined up to $250,000 for a felony and up to $100,000 for a misdemeanor, punishable by imprisonment up to six months. A corporation may be fined up to $500,000 for felony and up to $100,000 for a misdemeanor.\textsuperscript{381}

The bank regulatory agencies are considering whether to issue a regulation relative to codes of conduct through their regulatory powers regarding unsafe or unsound banking practices.\textsuperscript{382} The United States Department of Justice has also issued its policy respecting enforcement of the act.\textsuperscript{383}

G. RICO Civil Actions

Responding to the view that organized crime was a powerful threat to American industry, Congress in 1970 passed the Organized Crime Control Act.\textsuperscript{384} Section 1962 is the Racketeer Influence and Corrupt Organizations Statute, commonly referred to as “RICO”.\textsuperscript{385} RICO prohibits the following: (i) if a business or person receives income from a “pattern of

\begin{itemize}
\item \textsuperscript{379} Id. at § 215(b).
\item \textsuperscript{380} See id. at § 3623 (Supp. III 1985).
\item \textsuperscript{381} Id.
\item \textsuperscript{382} See, e.g., OCC, Banking Circular — 188 (Jan. 16, 1985) and Supplement 1, (July 10, 1985).
\item \textsuperscript{383} For copy of text, see 45 Wash. Fin. Rep. (BNA) No. 3, at 15 (1985).
\item \textsuperscript{384} Pub. L. No. 91-452, § 901(a), 84 Stat. 941.
\item \textsuperscript{385} 18 U.S.C. § 1962 (1982).
\end{itemize}
racketeering activity" or from a collection of an unlawful debt, it is illegal to use this money, directly or indirectly, to operate or acquire an interest in any "enterprise," (ii) a "pattern of racketeering activity" or a collection on an unlawful debt cannot be used to acquire or maintain, directly or indirectly, an interest or control in any enterprise, (iii) a person who is employed in any enterprise cannot conduct or participate in the conduct of that enterprise's affairs through a "pattern of racketeering activity" or collection of an unlawful debt, (iv) no person can conspire to do any of the above prohibited activities. The embrace of these prohibitions may result in a criminal or civil action and may go well beyond the realm of organized crime and into the traditional business and commercial world.

A "pattern of racketeering activity," as defined by RICO, requires at least two acts of racketeering activity within ten years of one another. "Racketeering activity" includes any act or threat of murder, kidnapping, gambling, arson, robbery, bribery, extortion or dealing in dangerous drugs, chargeable under state law and punishable by more than one-year imprisonment. Even more significantly for financial institutions, "racketeering activity" also includes many other specific acts such as counterfeiting, embezzlement, mail fraud, wire fraud and fraud in the sale of securities.

It is important to note that it appears the two offenses necessary to establish the pattern need not be related. For instance, an individual or business could engage in a "pattern of racketeering" by a fraudulent sale of securities in 1976 and mail fraud in 1985. Most jurisdictions have held that, although the predicate criminal acts must be connected to the enterprise, they need not be related to each other. Also, two repetitive acts in the same scheme, such as two sales of securities in one fraudulent security scheme, have been held by

386. Id.
389. Id. at § 1961(1).
390. Id.
many of the circuit courts to constitute a "pattern of racketeering activity" even if they occur on the same day. While a "pattern of activity" and a nexus with the defendant and the "enterprise" must be shown, it is not necessary to prove the defendant actually participated in the operation or management of the RICO "enterprise."

The United States Supreme Court has resolved a conflict between the United States Courts of Appeals for the Second and Seventh Circuits regarding certain restrictive standing requirements under RICO inferred by the Second Circuit. The Supreme Court has overruled the Second Circuit by holding that it was not necessary in a RICO civil action that the plaintiff show the injury was caused by an activity RICO was designed to deter and not simply by the "predicate acts" or that the two "predicate acts" had to consist of actual prior criminal convictions against the RICO defendant before the bringing of the civil RICO action. The effect of the Supreme Court's decision will be to broaden civil access to RICO and to leave to Congress any future limitations on RICO's availability.

Federal prosecutors almost routinely add RICO counts to indictments in business crime cases. The FDIC is now also using RICO in certain of its bank failure cases.

Congress has provided criminal sanctions under RICO and for civil action. More importantly, the statute provides a private right of action for any person injured in his business or property because of a RICO violation. Most significant to the private litigant is the authorization of treble damages, plus costs and reasonable attorney's fees.

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397. Id. at § 1964.

398. Id.
RICO concerns involving financial institutions have arisen recently regarding various "prime rate" litigation, stock fraud, mail fraud, antitrust violations and financing retail purchases of mobile homes. A bank can be sued under RICO for wrongful conversion of funds in an IRA to satisfy an account holder's obligation under a loan guaranty. Even professionals representing banks can be sued under RICO, for example, an accountant who assisted in the preparation and dissemination of false bank financial statements. Conceivably, RICO may become used, if the fact situations permit, by private litigants and the bank regulators to address serious cases of bank fraud or mismanagement and (by the bank regulators) for willful (for example criminal) violations of the banking laws.

H. Criminal Laws and False Statements

Generally, false statements, including a forged letter of credit, made to a federally insured banking institution can give rise to criminal liability if made to influence an institution's action "upon any application, advance, discount, purchase, purchase agreement, repurchase agreement, commitment, or loan." 400

VII. INTERNATIONAL LOAN CONSIDERATIONS

International loan related activities by United States banking institutions may be subject to statutorily prescribed supervision by the appropriate federal banking agency, to disclose regulation by the SEC, to federal anti-boycott legislation, and to foreign currency transaction reporting.

A. International Lending Supervision Act of 1983

Beginning in the 1970's United States banks increased their foreign lending activities without the benefit of a statutorily comprehensive regulatory or supervisory scheme. The

399. See Kaufman & Levin, supra note 384; Greenberg, supra note 391; and Comment, Civil RICO Actions in Commercial Litigation: Rackateer or Businessman?, 36 Sw L.J. 925 (1982).
International Lending Supervision Act of 1983 (ILSA)\(^{401}\) was enacted to address this situation and to "assure that the economic health and stability of the United States and the other nations of the world shall not be adversely affected or threatened in the future by imprudent lending practices or inadequate supervision" and achieve "the adoption of effective and consistent supervisory policies and practices with respect to international lending."\(^{402}\) ILSA applies to members of the Federal Financial Institutions Examination Council (FFIEC), including the FDIC, the Comptroller and the FRS.\(^ {403}\)

The federal banking agencies must evaluate foreign country exposure and transfer risk within banking institutions.\(^ {404}\) These factors must be taken into account when evaluating the capital adequacy of a banking institution.\(^ {405}\) The agencies began implementation of ILSA by issuing an interagency policy statement on the examination of international loans.\(^ {406}\)

ILSA requires a banking institution to establish and to maintain a special reserve if, in the judgment of the appropriate federal banking agency:

(A) the quality of such banking institution's assets has been impaired by a protracted inability of foreign public or private borrowers in a foreign country to make payments on their external indebtedness as indicated by such factors, among others, as —

(i) a failure by such public or private borrowers to make full interest payments on external indebtedness;

(ii) a failure to comply with the terms of any restructured indebtedness; or

(iii) a failure by the foreign country to comply with an International Monetary Fund or other adjustment program; or


\(^{403}\) Id. at § 3902.

\(^{404}\) Id. at § 3903.

\(^{405}\) See supra notes 95-132 and accompanying text.

(B) no definite prospects exist for the orderly restoration of
debt service.\footnote{630}

The special reserve must not be considered part of capital
and surplus or allowances for possible loan losses.\footnote{407} The spe-
cial reserve must be charged against current income and de-
ducted from loss loans.\footnote{408} The banking institution has the op-
ton of charging-off all or a portion of the international
loan.\footnote{409}

The appropriate federal banking agency must analyze the
results of foreign loan rescheduling negotiations, assess the
loan loss risk, and ensure that capital and reserve positions of
United States banking institutions are adequate to accommo-
date potential losses in the foreign loans.\footnote{410}

A banking institution can charge no more than the ad-
ministrative cost of restructuring an international loan, unless
the fee is amortized over the term of the loan.\footnote{411} The appro-
priate federal banking agencies have promulgated regulations
addressing the restriction on fees and the accounting treat-
ment for fees related to the restructuring of international
loans.\footnote{412}

A banking institution with foreign country exposure must
submit quarterly information regarding the exposure to the
appropriate federal banking agency.\footnote{413} It must also publicly
disclose foreign country exposure in relationship to assets and
capital.\footnote{414}

The appropriate federal banking agency must require
that a banking institution maintain adequate capital by estab-
lishing minimum capital levels.\footnote{415} Failure to maintain ade-
quate capital may be deemed an unsafe or unsound banking

(OCC); § 211.41 -.43 (FRS); 351.1-.3 (FDIC) (1986)).}
\footnotetext{408}{12 U.S.C. § 3904(b)(a)(2) (1986).}
\footnotetext{409}{Id.}
\footnotetext{410}{Id.}
\footnotetext{411}{Id. at § 3904(b).}
\footnotetext{412}{Id. at § 3905(a).}
\footnotetext{413}{12 C.F.R. § 20.9 (OCC); § 211.45 (FRS); § 351.2 (FDIC) (1986).}
\footnotetext{414}{12 U.S.C. § 3906(a) (Supp. III 1985) (codified at 12 C.F.R. § 20.10 (OCC); §
211.44 (FRS); § 351.2 (FDIC) (1986)).}
\footnotetext{415}{12 U.S.C. 3906(b) (Supp. III 1985).}
\footnotetext{416}{12 U.S.C. § 1818 (1982).}
practice. If a banking institution fails to maintain capital at or above its required level, the appropriate federal banking agency may issue a directive that requires the banking institution to adhere to a plan by which it shall achieve its required capital level. This directive and plan is enforceable in the same manner as a cease-and-desist order. The appropriate federal banking institution may consider the progress of a banking institution in adhering to a plan whenever the banking institution, an affiliate or the holding company that controls the institution seeks the approval of the appropriate federal banking agency for a proposal that would divert earnings, diminish capital or otherwise impede the progress of the banking institution in achieving its minimum capital level.

If one or more banking institutions extend credit aggregating more than $20 million to finance certain types of mining or metal related projects in a foreign country, written economic feasibility evaluation of the project must be prepared and approved in writing by a senior official of the banking institution prior to the extension of credit. The evaluation must consider several factors, including whether the credit can reasonably be expected to be paid from revenues generated by the prospect without regard to government subsidy. These evaluations shall be reviewed by the appropriate federal banking agency when conducting an examination of the banking institution. No private right of action or claim for relief may be based upon this requirement.

ILSA supplements, and does not detract from, agency powers under other laws which may be used to ensure compliance with ILSA, its regulations or orders. A banking institution and an officer, director, employee, agent or other person "participating in the conduct of the affairs" of the banking institution are subject to a civil penalty of $1,000 per day for

417. Id.
418. Id.
419. Id.
421. Id. at § 3908.
422. Id.
423. Id.
424. Id.
each day the violation continues.\textsuperscript{425} The General Accounting Office audits the banking agencies concerning their international regulation, supervision and examination activities.\textsuperscript{426}

B. SEC Disclosure Requirements

Bank holding companies registered with the SEC and engaged in lending to countries experiencing liquidity problems caused by economic and political conditions are required to make certain disclosures regarding these borrowers.\textsuperscript{427} Information regarding these situations is material to investors to assist them in making judgments about international lending activities that involve more than the normal credit risks.\textsuperscript{428} In order to provide investors with appropriate information, the SEC has issued disclosure guidelines for bank holding companies participating in lending arrangements with countries experiencing liquidity problems.\textsuperscript{429} These include the following minimal disclosures:

If conditions in a country may have a material impact on the payment of the country's public or private sector debt, and if the "outstandings" (loans, acceptances, interest bearing deposits with other banks and other investments) of the country that are payable to the bank holding company's total consolidated "outstandings," the country should be identified.

The amount of "outstandings" to identified countries should be stated in dollars, as a percentage of total amounts, or in a similar manner that indicates the magnitude of the "outstandings" to the identified countries. While the amount of "outstandings" may be aggregated, if the aggregate amount disclosed is concentrated in a particular country, the amount related to that country should be separately disclosed.

An indication of the effect that these conditions have had or are expected to have on the financial conditions or results or operations of the bank holding company should be provided.\textsuperscript{430}

\textsuperscript{426} Id. at § 3910.
\textsuperscript{427} SEC, Staff Accounting Bulletin No. 49, 47 Fed. Reg. 49,627 (1982).
\textsuperscript{428} Id.
\textsuperscript{429} Id.
\textsuperscript{430} Id.
The following information may be provided as an alternative to the above disclosures:

Identify each country in which the total public and private sector “outstandings” payable to the bank holding company exceed one percent of the company's total consolidated outstandings.

State the amount of “outstandings” to each identified country, as a percentage of total amounts, or in the similar manner that indicate the magnitude of the outstandings related to the identified country.

Discuss the impact if the “outstandings” to any of the identified countries have had or are expected to have a material adverse impact upon the registrant's financial condition or results of operations.\(^4\)

Bank holding companies provide current information at the time of periodic SEC filings or when material subsequent developments necessitate disclosure.\(^4\) An example of a material subsequent development is the negotiation or agreement to restructure existing debt and to obtain additional borrowings, between a foreign country and a U.S. lender, other foreign banks or international lending agencies.\(^4\) The disclosures include:

1. the nature of the negotiations and a general description of the agreements;
2. the impact on maturities of existing debt principal and on unpaid interest;
3. any commitments of the registrant to extend additional borrowings to a foreign country; and
4. any other arrangements, such as an agreement to maintain deposits in a foreign country with government banks.\(^4\)

Another example of a material development is the situation in which the central bank of a foreign government purchases the obligations for past due interest payments of certain private sector borrowers who otherwise had the ability to make the required interest payments on dollar denominated loans but were unable to exchange local currency for

\(^{431}\) Id.


\(^{433}\) Id.

\(^{434}\) Id.
the United States dollars. This enables the creditworthy private sector borrowers to comply with the terms of the loan agreements as to interest payments.

The following minimum disclosures are appropriate when the total loans by the bank holding company private sector borrowers in a foreign country are material in relation to the total of all loans by the registrant to that country:

(1) A description of the private sector payment mechanism;
(2) The amount of loans outstanding to private sector borrowers in the foreign country for which interest payments have been made under the payment mechanism, and the status of the principal payments due; and
(3) The amount of interest accrued on loans to private sector borrowers in the most recent fiscal year and interim period that has not been remitted in dollars to the U.S. bank. This disclosure may be excluded if the total interest and fees recognized on these loans during the most recent fiscal year are de minimus in relation to the total interest and fees recognized on foreign loans.

C. Foreign Currency Transaction Reporting

The Federal Currency and Foreign Transaction Reporting Act requires that transactions involving United States monetary instruments in excess of $10,000 between United States and foreign financial institutions be reported to the government pursuant to prescribed reporting procedures and forms. Failure to comply with this act may result in civil and criminal liabilities, and injunctive action by the government. More specifically, on July 5, 1985, the United States Treasury Department issued final rules requiring certain

435. Id.
436. Id.
437. Id.
439. Id. at § 5321.
440. Id. at § 5322.
441. Id. at § 5320.
United States financial institutions specified by the regulations to report financial transactions with foreign financial agencies.\textsuperscript{442}

IX. LIMITATIONS ON ALTERNATIVE FINANCING ARRANGEMENTS

Although without the scope of this article, the subject of alternative financing arrangements needs to be mentioned in the context of any present day discussion of commercial lending activities of banking institutions. Many banks, particularly the larger banking institutions, are evaluating whether they wish to continue on any large scale in the traditional commercial lending business. The reason for this reevaluation is two-fold: on the one hand, large corporate customers of these institutions are seeking alternative commercial financing arrangements through the commercial paper markets and securities and bond markets; while, on the other hand, commercial lending is becoming a more high-risk, low-return, middle-market phenomenon. Thus, to satisfy corporate clients and otherwise to increase institutional revenues and profits with a reduction of risk, many banking institutions are seeking alternative financing arrangements.\textsuperscript{443} Such arrangements can include: (i) lending of the institution's credit to a transaction by way of a standby letter of credit, guaranty or other institutional support facility;\textsuperscript{444} (ii) provision of investment banking-


\textsuperscript{443} See opening remarks of Dr. Alan Coleman, President of Southwestern Graduate School of Banking at opening of Second Annual Institute on Fundamentals of Commercial Lending (SMU School of Law 1986). However, note the paradox that last year smaller and middle-sized banks have seen a significant increase in commercial lending [see "Banks are Swimming in Loans," Am. Banker, March 4, 1986, at 28, col. 2] and thrift institutions are seeing a dramatic increase in this type of lending [see "Thrifts Surge Ahead in Commercial Lending," Am. Banker, March 10, 1986, at 34, col. 2].

\textsuperscript{444} See Boulder, Yield Enhancement Techniques for Banks, in NORTON-CLG, supra note 3, at ch. 27.
type services such as public and private placement of commercial paper and other private placement or underwriting related activities;\textsuperscript{445} and (iii) actual direct involvement in certain lending situations through sale-leaseback, joint venture and profit participation arrangements.\textsuperscript{446} The future of these possible activities is, however, surrounded by a host of legal considerations and impediments.

A. Restrictions on Activities

Restrictions on alternative financing arrangements can include: (i) statutory and regulatory limitations on the issuance of a guaranty by a banking institution,\textsuperscript{447} (ii) regulatory restrictions on the issuances of standby letters of credit,\textsuperscript{448} (iii) Glass Steagall Act restrictions on a bank's investment banking type activities,\textsuperscript{449} (iv) limitations on the type of investments a banking institution can acquire,\textsuperscript{450} (v) limitations on a banking institution's ownership of real estate\textsuperscript{451} and (vi) limitations on a banking institution's being a joint venture or general partner.\textsuperscript{452}

B. Restrictions on Vehicles

Even though a banking institution may not be prohibited by certain statutory or regulatory barriers such as the Glass Steagall Act, the institution cannot assume that it has express or incidental powers to engage in such activities. Here the bank regulators still control the lever, not only in terms of permitting the activity but also in terms of the structural implementation of the activity, whether through the bank or S&L directly or indirectly through a subsidiary of the bank or

\textsuperscript{445} See Norton, Up Against "The Wall": Glass-Steagall and the Dilemma of a Deregulated ("Reregulated") Banking Environment, accepted for publication in February 1987 Bus. Law.

\textsuperscript{446} See Snakard, Alternative Commercial Real Estate Financing Arrangements, in Norton-CLG, supra note 3, at ch. 32.

\textsuperscript{447} See, e.g., 12 C.F.R. § 7.7010 (1986).

\textsuperscript{448} See supra notes 359-66 and accompanying text.

\textsuperscript{449} See supra text accompanying note 24; Norton, Up Against "The Wall", supra note 445.

\textsuperscript{450} See, e.g., 12 C.F.R. § 1 (1986).

\textsuperscript{451} See Snakard, supra note 446, at § 32.06.

\textsuperscript{452} Id. at § 32.05.
S&L or through a non-bank or non-S&L holding company subsidiary.

An example of this structural dilemma has been the debate among the regulators and in Congress as how to expand the securities and other powers of banks. The Treasury Department and the FRB, would like to see any such expansion through separate non-bank subsidiaries of holding companies. This vehicle is thought to be more identifiable for regulatory purposes and to isolate, to some degree, the bank from liability or loss exposure. The Comptroller, at times, has indicated such an approach may be form over substance and appears not so much concerned by direct bank involvement, or by bank subsidiary involvement, and selected securities activities, provided adequate regulatory safeguards are effective. The FDIC approach is: to permit state, non-FRS member banks to engage in securities activities through "bona fide securities subsidiaries" with separate and distinct accounts, records and management; to prohibit using a common name or logo with the bank; to require adequate capital, as reviewed by the FDIC on a case by case basis; to restricting lending between a bank and securities subsidiaries; and to limit securities that can be underwritten (for example "investment quality" equity and debt securities). Although the FHLBB views the Glass Steagall Act as inapplicable to thrift institutions to exercise powers in the securities area, such powers have been granted for limited activities, normally to be conducted through a separate service corporation subsidiary.


454. See supra note 123.


456. See 12 C.F.R. § 545.82.
X. CONCLUDING OBSERVATIONS: RISING IMPORTANCE OF EXAMINATION AND SUPERVISORY FUNCTIONS OF BANK REGULATORS

There are practical lessons to be learned from the existence of this complex scheme of bank regulation of lending activities. First, is the overall appreciation of the fact that, in addition to the "normal" type of commercial law problems entailed in commercial lending, the regulated framework within which banking institutions operate give rise to sundry "peculiarized" legal concerns under federal banking regulation. Second, in any effective underwriting of a commercial loan transaction by a banking institution, these types of legal concerns must "filter" into the overall underwriting process. But, third and more importantly, on a broader institutional level, bank officers and their counsel must be sensitive to the present regulatory environment, which is effectively one of "reregulation" and not "deregulation." New business opportunities have been made for banking institutions and, most probably, further expanded opportunity will come. However, from a countervailing perspective, the bank regulators have recently been reassessing their approach to the basic banking objective of safety and soundness.

What must be understood concerning this new regulatory focus on safety and soundness is that such reevaluation, and for that matter, much of bank "reregulation" today, is occurring in large part through the examination and supervisory functions of the regulators.\(^\text{457}\) When considering the types of assessments being made; (i) on the ratings of banking institutions under the CAMEL system, (ii) on the classification and "scheduling" of assets generally, (iii) on the provisions for adequate loan loss reserves, (iv) on the proposed risk-based capital requirements, (v) on the assessment of real estate assets\(^\text{458}\) and (vi) on the general intensification and broadening of FRB examination and supervision of bank holding company units, the most significant impact that this often subjective and \textit{ad hoc} world of examination and supervision can have on


\(^{458}\) See Whitley, Real Estate Regulations Affecting Banking Institutions and Other Commercial Lenders, in NORTON-CLG, supra note 3, at § 33.10.
banking institutions generally and on their lending functions specifically becomes apparent.

In the present environment, the bank regulators, as examiners and supervisors, are highly concerned about such matters as:

- Excessive competition in a deregulated market, which has caused more bankers to undertake a follow-the-leader type of analysis rather than exploring a market niche;
- Liberalized credit standards by banks, without a corresponding re-adjustment of internal safeguards to monitor borrowers accepted under the liberalized standards;
- Bankers' education, which has not kept up with changes in various industries. For example, major industries experiencing change presently include high technology, airline and agriculture. There are many old loan agreements still in place in relationship to these rapidly changing industries and new loan agreements that were clearly structured by individuals who did not understand the new rules related to these industries;
- Difficulties experienced by collateral lenders. A collateral lender is a banking institution that does not rely on the cash flow of the borrower to service the debt. Rather, it relies on the valuation of the underlying collateral to value the debt. These types of lenders have suffered particularly in the industries of agriculture, oil and gas, real estate and computer production (where obsolescence is a major concern with backlogged inventory);
- Speculation, especially in the area of real estate construction and high tech. Bankers make loans with a percentage of the "deal" hoping that the industry will improve or mature prior to loan repayment;
- Continued abuses of insider, affiliate and correspondent transactions;
- Excessive concentrations of related loans, either by industry classification or by borrower and "affiliate" groupings;
- International lending exposure; and
- Rapid movement into off-balance sheet activities and into investment banking-related activities.459

The response to these and other concerns by the regulators has been an increased concern for enhanced capital

459. Id.
adequacy requirement, upgrading of bank underwriting and internal credit allocation processes, improvement of bank internal controls respecting such matters as insider, affiliate and correspondent transactions and, in some instances, required public disclosure of bank mismanagement.

In summary, not only federal regulations but also trends evidenced in the examinations and supervision practices of the regulators should be of concern to banking institutions. Especially, there should be concern in the context of structuring and consummating a particular commercial loan transaction and, even more importantly, in the context of formulating, implementing and monitoring prudent, internal lending practices and policies by such institutions and policies on alternative commercial, financial services.