SBD Opinion 2012–01 – Credit Exposure Limits[1] **December 7, 2012**

General Guidance on Credit Exposure Limits and Debt Aggregation (Pursuant to Alabama Banking Code Section 5-5A-22 and Alabama Banking Board Regulation No. 14)

As stated in Regulation No. 14, the purpose of statutory loan limits is to prevent one borrower or a relatively small and economically related group from borrowing an unduly large portion of the bank's capital. Credit Exposure Limits on credit exposures are in place for the worst-case scenario of default to prevent losses to one borrower and their related interests or group of associated borrowers from putting banks in unsafe and unsound conditions through loss of capital. Consequently, when banks determine concentrations of credit risk and aggregation of credit exposures for Credit Exposure Limit purposes, the banks should start from the perspective of asking: Are the credit exposures so related that they would all be impaired or in default in the event of a default on one or more of the other loans or exposures? Generally, the Alabama State Banking Department has followed the principal that if a borrower, related entities, or group of borrowers made the decision to borrow a large portion of the capital of a bank, they will also together control the decision whether the related loans are repaid or are defaulted upon through diversion of cash flows.

Regulation No. 14 and Alabama Banking Code §5-5A-22 require diversification of credit risk through banks spreading loans out among a relatively large number of creditworthy borrowers who are not economically related. The Code section and Regulation No. 14 require procedures and processes where all direct or indirect loans to borrowers, their partnerships, firms, limited liability companies, corporations, or unincorporated associations must be aggregated and regarded as single loans. Regulation No. 14 focuses on individual borrowers, their related companies, and associated groups of individual borrowers and their related companies.

There are rules in place in Regulation No. 14 dealing with aggregation of debts to individual borrowers and groups of associated borrowers. Some of the rules, dealing with percentage ownership of businesses, guarantees, and liability of partners deal with principles of legal liability for debts and standards for presumption of control. An analysis of aggregation of debts should not begin there and cannot stop there. Regulation No. 14 requires that banks first look at additional factors such as:

1. What borrowers, groups of borrowers, or entities would benefit from the extension of credit? Common benefit requires aggregation.
2. What borrowers, groups of borrowers, or entities are responsible for repayment or serve as the repayment source for the extension of credit? Common repayment sources or responsibility requires aggregation[2].

[1] Because of the addition of limits on credit exposure from derivatives and securities financing transactions to the prior limits that applied only to loans or extensions of credit, the terminology used in Regulation No. 14 and in this Opinion refers to "Credit Exposure Limits" which is a term adopted to apply to the limits contained in this Regulation No. 14 and those in Alabama Banking Code §5-5A-22 that have previously been referred to as "legal lending limits."

[2] The question has been asked whether the debts of a large group of otherwise unrelated borrowers, such as employees of a local hospital or poultry farmers who sell to the same poultry companies, should be aggregated for Credit Exposure Limit purposes because of an apparent common repayment source. These loans may represent a concentration, but the answer to these questions, for Credit Exposure Limit purposes, is normally no. These individuals are not Associates that

3. For what purpose were loans to borrowers, groups of borrowers, or entities made? Common purpose requires aggregation.
4. Is there common control among borrowers, groups of borrowers, or entities? Common control requires aggregation.

Examples

The following examples illustrate many of the points above and particular provisions of Regulation No. 14 and §5-5A-22. These examples are provided for illustrative purposes only and are designed to recreate common misinterpretations of the application of the Credit Exposure Limits by bank management.

These examples all relate to hypothetical ABC Bank which has $10,000,000 in capital and reserves as of the date of its most recent (12-31-2012) Call Report. Consequently, ABC Bank has a $1,000,000 unsecured Credit Exposure Limit (10% of capital and reserves) and a $2,000,000 total secured and unsecured Credit Exposure Limit (20% of capital and reserves) for purposes of the examples. Each example follows the process below for determining compliance with the Credit Exposure Limits.

Process for Determining Application of Credit Exposure Limits to Credit Exposures

1. Determine the borrower or group of borrowers whose debts should be looked at to determine if they should be aggregated. This is perhaps the most important step in the process. Individuals, the individuals' family members, and groups of associated individuals that are in business together as well as their businesses should be looked at to see whether debts owing by any to the bank should be aggregated. [Refer to Regulation No. 14, Section 6 b. that states that debts of one borrower or a relatively small and economically related group, including all direct or indirect loans to Persons, their partnerships, firms, limited liability companies, corporations, or unincorporated associations, must be aggregated and regarded as single loans. Particular attention should be given to Section 6 b. (i. and ii.) as well as the definitions of Person, Associate, Controlled Company and Counterparty 1 a., 1 c., 1 d. and 1 h. of Regulation No. 14.]

2. Determine the debts of each borrower or the group of borrowers that need to be aggregated by looking at:
    a. Common benefit from the loans,
    b. Common repayment sources for the loans,
    c. Common purpose for the loans,
    d. Common control among the entities receiving the loans, and
    e. Aggregation rules of §5-5A-22(c)(2)(a.-f.) and of Regulation No. 14, Section 6 b. (i.-viii.).

are economically related; i.e., they are not in business together. In the cases of these loans, there is no common benefit, no common purpose, and no common control. The related repayment source is substitutable. Employees of the hospital can take employment elsewhere. Poultry farmers can sell their product to another poultry company. As an example, these cases are different from the case of a small group of borrowers that are in the real estate development business together, where the repayment source is actually the sale of the bank's collateral, where common control is frequently exercised over a number of projects and the cash flows therefrom, where there is frequently common benefit, and the individuals are commonly responsible to varying degrees for repayment.

3. Determine the proper amount of each loan to be counted for Credit Exposure Limit purposes (e.g., full amount of line of credit vs. amount drawn) and calculate the secured and unsecured totals of the aggregated loans (Refer to Regulation No. 14, Sections 1 g., 2, and 3).

4. Deduct any loans that are exceptions to being counted for aggregation per §5-5A-22(d)(1)-(4) or Regulation No. 14, Section 4 (e.g., loans secured by own bank CDs).

5. Check the total of unsecured loans against the bank's 10% unsecured Credit Exposure Limit. (Refer to Section 5-5A-22, Sections (a) and (c)(1) and Regulation No. 14, Sections 1 b., 2, and 3.)

6. Check the total of secured and unsecured loans against the bank's 20% total unsecured and secured Credit Exposure Limit. (Refer to Section 5-5A-22, Sections (a) and (c)(1) and Regulation No. 14, Sections 1 b. and 2. In the case of an extension of credit to an insider to which Federal Reserve Board Regulation O would apply, refer to Regulation No. 14, Appendix 2 – Calculation of Credit Exposure Limits for Insider Loans: State Banking Board Regulation No. 14 and Federal Reserve Board Regulation O.)

<u>EXAMPLE 1 – Definition of a Loan, Standby Letters of Credit</u>

On February 1, 2013, Individual Borrower B applies for a $700,000 loan from ABC Bank to purchase a vacation home. The loan is to be secured by a first mortgage on the vacation home that has an appraised value of $1,000,000.

<u>Step 1</u>: Determine the borrower or group of borrowers whose debts should be looked at to determine if they should be aggregated.

The loan officer knows that Individual Borrower B owns 100% of Corporation A and Corporation A already has loans from ABC Bank. The loan officer appropriately decides to look at whether the loans of Individual Borrower B and Corporation A should be combined for Credit Exposure Limit purposes.

<u>Step 2</u>: Determine the debts of each borrower or the group of borrowers that need to be aggregated by looking at:

a. Common benefit from the loans,
b. Common repayment sources for the loans,
c. Common purpose for the loans,
d. Common control among the entities receiving the loans, and
e. Aggregation rules of §5-5A-22(c)(2)(a.-f.) and of Regulation No. 14, Section 6 b. (i.-viii.).

The loan officer determines that Corporation A owes the bank $1,200,000 on a commercial real estate loan secured by 30 residential lots having a combined appraised value of $2,000,000. ABC Bank has also issued two standby letters of credit for Corporation A totaling $300,000. Individual Borrower B guarantees the $1,200,000 loan and the $300,000 in standby letters of credit of Corporation A through an unlimited, continuing guaranty.

The loan officer determines to decide whether the debts of Corporation A and Individual Borrower B should be combined for Credit Exposure Limit purposes. He determines that it is unknown whether there is common benefit, but does decide that there is clearly a common primary repayment source since Individual Borrower B's primary livelihood and cash flow come from the profits of Corporation A. The loan officer also determines that there is no common purpose, but there is clearly control exercised by Individual Borrower B since he owns 100% of Corporation A and since Regulation No. 14 states, in Section 6.b.iii., that if a borrower owns 35% or more of a corporation or limited liability company by stock ownership or otherwise, the direct or indirect loans to this company and to the borrower would be treated as one loan to the borrower. Individual Borrower B is also liable for the debts of Corporation A through the unlimited, continuing guaranty of Corporation A's debts, and those debts guaranteed must be aggregated per Section 6.b.iv., of Regulation No. 14.

<u>Step 3</u>: Determine the proper amount of each loan to be counted for Credit Exposure Limit purposes (e.g., full amount of line of credit vs. amount drawn) and calculate the secured and unsecured totals of the aggregated loans (Refer to Regulation No. 14, Sections 1 g., 2, and 3).

The loan officer determines that the following loans should be counted and aggregated for Credit Exposure Limit purposes:

Individual Borrower B	\$700,000 secured (by vacation home)
Corporation A	\$1,200,000 secured (by 30 residential lots)
Total	\$1,900,000 (all secured)

However, the loan officer does not include the \$300,000 in unsecured standby letters of credit issued for Corporation A. [The definition of extension of credit in Regulation No. 14 is the same as in FRB Regulation O and includes "issuance of a standby letter of credit."]

<u>Step 4</u>: The loan officer determines that none of the exceptions in §5-5A-22(d)(1)-(4) apply to these loans, and the collateral on the loans does not meet the requirements of Regulation No. 14, Section 4 for the loans to be considered as exceptions under 5-5A-22(d)(5) since it is not cash or equivalent to cash and does not have a readily established market value.

<u>Step 5:</u> Check the total of unsecured loans against the bank's 10% unsecured Credit Exposure Limit.

The loan officer determines that none of the aggregated debts of Individual Borrower B and Corporation A are unsecured. This represents an error due to his error in Step 3 of not counting the \$300,000 in unsecured standby letters of credit. However, the \$300,000 would still be well below ABC Bank's \$1,000,000 unsecured Credit Exposure Limit and would not constitute a violation of the unsecured Credit Exposure Limit.

<u>Step 6</u>: Check the total of secured and unsecured loans against the bank's 20% total unsecured and secured Credit Exposure Limit.

The loan officer determines that the \$1,900,000 (including the \$700,000 loan applied for) in combined debts of Individual Borrower B and Corporation A that was arrived at in Step 3 is below ABC Bank's combined Credit Exposure Limit of \$2,000,000. Consequently, he decides to go ahead and make the \$700,000 loan to Individual Borrower B that is closed and funded on February 5th. **The making of this \$700,000 loan is, however, a violation of the bank's combined Credit Exposure Limit since the \$300,000 in unsecured standby letters of credit should have been included and would bring the aggregated debt to \$2,200,000.**

<u>EXAMPLE 2 – Execution of Participations, Amount of Loan</u>

On February 2, 2013, Limited Liability Company A ("LLC A") applies for a $5,000,000 closed-end acquisition and construction loan from ABC Bank, to be fully funded through draws during the construction phase, to purchase land and construct a hotel and related amenities. Collateral for the loan consists of a first real estate mortgage and security agreement on the land and proposed hotel, amenities, and personal property with an "as completed" market value of $7,500,000.

<u>Step 1</u>: Determine the borrower or group of borrowers whose debts should be looked at to determine if they should be aggregated.

The loan officer decides, for Credit Exposure Limit purposes, to look for other debts of LLC A and to also look at any individual debts of the principals of LLC A or other entities in which they are involved to see if those other debts should be aggregated.

<u>Step 2</u>: Determine the debts of each borrower or the group of borrowers that need to be aggregated by looking at:

a. Common benefit from the loans,
b. Common repayment sources for the loans,
c. Common purpose for the loans,
d. Common control among the entities receiving the loans, and
e. Aggregation rules of §5-5A-22(c)(2)(a.-f.) and of Regulation No. 14, Section 6 b. (i.-viii.).

The loan officer knows that LLC A is a newly formed entity formed for the sole purpose of purchasing the land and building the hotel. Consequently, there are no existing loans from ABC Bank to LLC A. The loan officer has not dealt with the principals in LLC A previously, but he checks the banks records and determines that there are no outstanding loans from ABC Bank to the principals or other entities in which they are involved. Consequently, the loan officer only has to consider the newly requested $5,000,000 loan for Credit Exposure Limit purposes.

<u>Step 3</u>: Determine the proper amount of each loan to be counted for Credit Exposure Limit purposes (e.g., full amount of line of credit vs. amount drawn) and calculate the secured and unsecured totals of the aggregated loans (Refer to Regulation No. 14, Sections 1 g., 2, and 3).

Since the loan officer determined in Step 2 that only the $5,000,000 loan needs to be considered, he knows that the loan will only be counted against the secured Credit Exposure Limit because it is secured by real estate collateral and all mortgages and legal documents perfecting the lien will be recorded. He already knows that ABC Bank's secured Credit Exposure Limit is only $2,000,000 so he calls the President of XYZ Bank to see if XYZ Bank would be interested in participating in the loan. After sending the documentation to XYZ Bank, the President of XYZ Bank agrees to participate in the loan and the loan officer puts a memo in file to document that agreement. ABC Bank and XYZ Bank, however, do not execute a formal participation agreement at that time. They agree to do so when the draws on the loan reach $2,000,000.

Based on the agreement with XYZ Bank to participate in the loan when it reaches ABC Bank's secured Credit Exposure Limit, the loan officer counts the loan amount for Credit Exposure Limit purposes as follows:

LLC A	$5,000,000 secured (by land and hotel under construction)
Less:	<u>$3,000,000</u> participation sold (verbally agreed to by XYZ Bank)
Total	$2,000,000 (all secured)

The loan officer appropriately included the entire committed amount of construction loan, but **by not executing a formal participation agreement, the loan officer disregarded the part of Section 1 g. ii. which says "If a bank chooses to assign or participate all or part of a loan to another bank to comply with Credit Exposure Limits, the assignment or participation documents establishing the assignee or participating bank's firm legal commitment to fund the assigned or participated amount must be executed prior to or on the same business day as the loan documents in order for the full amount of the loan to not be considered for Credit Exposure Limits. Furthermore, if the terms of the participation agreement fail to qualify for sales treatment as defined by FASB Statement No. 166, Accounting for Transfers of Financial Assets, the total amount of the loan should be included when determining compliance with Credit Exposure Limits."**

<u>Step</u> 4: The loan officer determines that none of the exceptions in §5-5A-22(d)(1)-(4) apply to this loan, and the collateral does not meet the requirements of Regulation No. 14, Section 4 for the loan to be considered an exception under 5-5A-22(d)(5) since it is not cash or equivalent to cash and does not have a readily established market value.

<u>Step 5:</u> Check the total of unsecured loans against the bank's 10% unsecured Credit Exposure Limit.

The loan officer recognizes that the loan is secured, and he does not need to consider the unsecured Credit Exposure Limit.

<u>Step 6</u>: Check the total of secured and unsecured loans against the bank's 20% total unsecured and secured Credit Exposure Limit.

The loan officer determines that the $2,000,000 amount of the loan remaining after the $3,000,000 participation is sold to XYZ Bank does not exceed ABC Bank's secured Credit Exposure Limit of $2,000,000. He obtains the approval of ABC Bank's loan committee, and the $5,000,000 acquisition and construction loan to LLC A is closed on February 6, 2013. The formal participation agreement is not executed with XYZ Bank until June 30, 2013. **The closing of this loan on February 6, 2013 is a violation of Regulation No. 14 because the loan officer and loan committee did not consider Section 1 g. ii. of Regulation No. 14 requiring that "the assignment or participation documents establishing the assignee or participating bank's firm legal commitment to fund the assigned or participated amount must be executed prior to or on the same business day as the loan documents in order for the full amount of the loan to not be considered for Credit Exposure Limits. Furthermore, if the terms of the participation agreement fail to qualify for sales treatment as defined by FASB Statement No. 166, Accounting for Transfers of Financial Assets, the total amount of the loan should be included when determining compliance with Credit Exposure Limits."**

EXAMPLE 3 – Collateral Values

On February 3, 2013, Individual Borrower A applied for a $1,250,000 term loan from ABC Bank to be secured by an assignment of Borrower A's 50% membership interest in XYZ, LLC. The loan officer prepares internal loan approval documents showing a reported a collateral value of $1,500,000 based on 50% of the book value of XYZ, LLC's Members' Capital accounts shown on the LLC's financial statements as of December 31, 2012. The loan officer determines and documents in the loan file that XYZ, LLC is a single asset entity formed in 2007 to develop a 40-unit condominium project, and 20 units remained unsold.

Step 1: Determine the borrower or group of borrowers whose debts should be looked at to determine if they should be aggregated.

The loan officer decides to check ABC Bank's records and determine whether the bank has existing loans to Individual Borrower A, or XYZ, LLC and other principals of XYZ, LLC and their related interests so that he can determine if any such debts should be aggregated.

Step 2: Determine the debts of each borrower or the group of borrowers that need to be aggregated by looking at:

a. Common benefit from the loans,
b. Common repayment sources for the loans,
c. Common purpose for the loans,
d. Common control among the entities receiving the loans, and
e. Aggregation rules of §5-5A-22(c)(2)(a.-f.) and of Regulation No. 14, Section 6 b. (i.-viii.).

The loan officer determines that there are no existing loans outstanding from ABC Bank to XYZ, LLC including no existing loans to Individual Borrower A or the other principals of XYZ, LLC. Consequently, only the $1,250,000 requested loan to Individual Borrower A needs to be considered for Credit Exposure Limit purposes.

Step 3: Determine the proper amount of each loan to be counted for Credit Exposure Limit purposes (e.g., full amount of line of credit vs. amount drawn) and calculate the secured and unsecured totals of the aggregated loans (Refer to Regulation No. 14, Sections 1 g., 2, and 3).

Since the loan officer determined that only the $1,250,000 requested by Individual Borrower A needs to be considered for Credit Exposure Limit purposes, he determines whether that $1,250,000 loan should be considered as secured or unsecured. As noted previously, the loan is to be secured by an assignment of Borrower A's 50% membership interest in XYZ, LLC. The loan officer prepares internal loan approval documents showing a reported a collateral value of $1,500,000 based on 50% of the book value of XYZ, LLC's Members' Capital accounts shown on the LLC's financial statements as of December 31, 2012. Based on that financial statement and assignment of ownership interest, he considers the $1,250,000 to be totally secured.

He, however, is aware (and documents in the loan approval memo) that a $3,000,000 loan secured by the remaining condominium units from Bank B to XYZ, LLC was in default and judicial foreclosure proceedings were pending prior to the February 3, 2013 loan request and application. He is also aware that the proceeds of the $1,250,000 loan requested by Individual Borrower B will not be used to prevent the foreclosure by Bank B. He does not consider whether Regulation No. 14, Section 3 may apply to this loan.

Step 4: The loan officer determines that none of the exceptions in §5-5A-22(d)(1)-(4) apply to this loan, and the collateral does not meet the requirements of Regulation No. 14, Section 4 for the loan to be considered an exception under 5-5A-22(d)(5) since it is not cash or equivalent to cash and does not have a readily established market value.

Step 5: Check the total of unsecured loans against the bank's 10% unsecured Credit Exposure Limit.

The loan officer has decided (in Step 3) that the loan is secured, and he does not consider the unsecured Credit Exposure Limit. The loan officer; however, does not recognize that the ownership interest in XYZ, LLC that is to be taken as collateral is essentially valueless. The loan officer disregards the fact that the condominium project is the LLC's only asset. He disregards the fact that the LLC has not sold a unit in the project in over a year and that the LLC has no cash flow for debt service other than through sales. He disregards the fact that when Bank B forecloses on the condo project, XYZ, LLC will have no tangible assets. If the loan officer had considered all of the above facts, he would have (per Regulation No. 14, Section 3) considered the $1,250,000 loan to be unsecured and measured it against ABC Bank's $1,000,000 unsecured Credit Exposure Limit to determine that ABC Bank could not make the loan.

Step 6: Check the total of secured and unsecured loans against the bank's 20% total unsecured and secured Credit Exposure Limit.

The loan officer obtains the necessary committee approval, closes the loan on February 7, 2013, and continues to consider the $1,250,000 loan to be secured and within ABC Bank's $2,000,000 secured Credit Exposure Limit. However, at the next bank examination, the examiners consult with the Superintendent and determine that the $1,250,000 loan should be considered unsecured. They write up the loan in the examination report as a violation of Section 5-5A-22 and Regulation No. 14. They cite Section 3 of Regulation No. 14 which states: *"A loan or credit exposure may be purported to be secured but, for Credit Exposure Limit purposes, may, in the opinion of the Superintendent, be considered unsecured. Such a case could come about where the stated collateral is so poor as to have little value, where the lien on the collateral is not perfected within a reasonable time, or where a combination of factors including, but not limited to, missing documentation of the bank's lien position, amount of collateral, location of collateral, or condition of collateral casts substantial doubt on the collateral's existence or value. In such cases, the Superintendent shall provide the bank a period of time, determined by the Superintendent, to correct the documentation deficiencies, prove the value of the collateral, obtain additional collateral, or otherwise correct the violation before imposing the penalties prescribed by §5-5A-22."* Consequently, when the examination report is transmitted to ABC Bank, the Superintendent gives the bank 30 days to prove the value of its collateral. ABC Bank cannot do so, and Bank B completes the foreclosure during the 30 day period.

EXAMPLE 4 – Common Purpose, Benefit, and Source of Repayment

On February 4, 2013, ABC Bank renews a $1,950,000 acquisition and development loan to Limited Liability Company B ("LLC B") for one year with interest payable quarterly and all principal due on February 4, 2014. Collateral consists of 18 developed residential lots and 20 acres of excess land with a combined "as is" market value of $2,300,000. LLC B has four members (Member 1, Member 2, Member 3, and Member 4) each holding a 25% ownership interest in LLC B. Also, each member provides a limited guaranty of $625,000 for the loan. An internal guarantor analysis performed at this renewal indicates that the guarantors have minimal capacity to repay the loan from personal resources.

On March 4, 2013, Limited Liability Company C ("LLC C") requests an unsecured, $150,000 single payment loan from ABC Bank reportedly for working capital purposes of LLC C. The loan officer determines that the primary source of repayment is excess proceeds from the sale of the real estate securing the loan to LLC B above. LLC C consists of the same members and ownership percentage interests as outlined above for LLC B, and each member provides a limited guaranty of $50,000.

Step 1: Determine the borrower or group of borrowers whose debts should be looked at to determine if they should be aggregated.

The loan officer decides to check ABC Bank's records and determine whether the bank has existing loans to LLC C and its Members 1, 2, 3, and 4 and their related interests to determine what debts of individual borrowers or groups should be considered for aggregation for Credit Exposure Limit purposes. **The loan officer, however, does not determine whether the members of LLC B and LLC C (all the same) may be considered as "Associates" or a "small or economically related group" or an "unincorporated association" and whether the LLCs are "controlled companies" according to Regulation No. 14, Sections 1 a., 1 c., 1. h. and 6 b.**

Step 2: Determine the debts of each borrower or the group of borrowers that need to be aggregated by looking at:

a. Common benefit from the loans,
b. Common repayment sources for the loans,
c. Common purpose for the loans,
d. Common control among the entities receiving the loans, and
e. Aggregation rules of §5-5A-22(c)(2)(a.-f.) and of Regulation No. 14, Section 6 b. (i.-viii.).

Analysis of Individuals' Debts

The loan officer decides to determine whether debts should be aggregated from the standpoint of the individual Members of LLC C. Consequently, he looks for existing debts of each Member of LLC C (same as LLC B). He determines to look at the outstanding debts of each member as follows:

Member 1

1st Mortgage Loan on Home (secured)	$100,000
Loan on F-150 Pickup Truck (secured)	$28,000
Loan of LLC B (secured)	$1,950,000

(See Step 3 below where the loan officer properly does not include all of LLC B's debt per Regulation No. 14, Section 6 b. iii. since Member 1 owns less than 35% of LLC B, but does [per Regulation No. 14, Section 6 b. iv.] include the amount of Member 1's limited guaranty of LLC B's debt.)

Loan of LLC C (unsecured)	$150,000

(See Step 3 below where the loan officer properly does not include all of LLC C's debt per Regulation No. 14, Section 6 b. iii. since Member 1 owns less than 35% of LLC C, but does [per Regulation No. 14, Section 6 b. iv.] include the amount of Member 1's limited guaranty of LLC C's debt.)

Members 2, 3, and 4

The loan officer determines that Members 2, 3, and 4 have no other outstanding debts with ABC Bank. Consequently, each of their individual total debts for Credit Exposure Limit purposes would be the amounts of the debts of LLC B and LLC C which they guarantee and for which they are liable or which must be aggregated per the rules of Section 6 b. (i – viii). See Step 3 below where the loan officer properly only includes the unsecured $50,000 limited guaranty of LLC C's debt and the $675,000 secured and unsecured total of the $625,000 guaranty of the secured debt of LLC B plus the $50,000 guaranty of the unsecured debt of LLC C.

Analysis of Debts of Group as Associates

LLC B and LLC C

While the loan officer looked at combining debts from the standpoint of the individual members of LLC B and LLC C, he failed, in Step 1, to look at the group of members as "Associates" or a "small or economically related group" or "unincorporated association" according to Regulation No. 14, Section 6 b. Consequently, he did not look at whether the debts of LLC B and LLC C should be combined. If he had, he would have gone through the following analysis:

a. Common benefit from the loans,

   In looking at the four common members of the LLCs as a group, there is clearly common benefit to the group. Consequently, the loans of LLC B and LLC C should be combined.

   The loan officer should look at whether the individual loans to Member 1 represent common benefit to the LLCs and their members as a group. The individual loans to Member 1 were used to purchase Member 1's home and truck and did not benefit the LLCs or the other members as a group.

b. Common repayment sources for the loans,

In looking at repayment sources, the primary repayment source of the loan to LLC C is the same (sale of the real estate of LLC B) as that of the loan to LLC B. Consequently, the loans of LLC B and LLC C should be combined.

The loan officer also should look at whether the personal loans to Member 1 should be combined with the loans to the LLCs; however, Member 1 has a salaried job that is unrelated to either LLC and is marginally able to service his individual debts. Consequently, there is not a common repayment source for those individual loans to Member 1, and they would not be combined with the LLCs' debts.

c. Common purpose for the loans,

In looking at the purpose of the loan to LLC C, Member 1 reports (and subsequently bank records confirm) that the $150,000 in loan proceeds to LLC C were to be used to make delinquent interest payments on the $2,450,000 loan to LLC B and to pay off mechanic liens attached to the underlying real estate collateral of the loan to LLC B. Consequently, it is clear that there is common purpose of the loans to LLC B and LLC C, and those loans should be combined.

The individual loans to Member 1 were made to purchase Member 1's home and truck and there is no common purpose with the loans to the LLCs.

d. Common control among the entities receiving the loans,

By looking at the four common members of the LLCs as a group, it is clear that there is common control of LLC B and LLC C by the group. Consequently, the loans of LLC B and LLC C should be combined.

There is no common control of repayment on the personal loans of Member 1 since he is solely responsible for those loans and the other members of the LLCs are not responsible for or control repayment of those loans.

e. Aggregation rules of §5-5A-22(c)(2)(a.-f.) and of Regulation No. 14, Section 6 b. (i.-viii.).

By looking at Section 6 b. and particularly the definitions of Person, Associate, and Controlled Company 1 a., 1 c. and 1 h. of Regulation No. 14, the loan officer would have confirmed that the four common members of the LLCs should be looked at as a group. Section 6 b. (viii) would likely indicate that the loan to LLC C should be aggregated with the debt of LLC B since the proceeds were used to catch up delinquent interest payments on the LLC B loan thereby showing common responsibility.

<u>Step 3</u>: Determine the proper amount of each loan to be counted for Credit Exposure Limit purposes (e.g., full amount of line of credit vs. amount drawn) and calculate the secured and unsecured totals of the aggregated loans (Refer to Regulation No. 14, Sections 1 g., 2, and 3).

<u>Analysis of Individuals' Debts</u>

As noted previously, the loan officer combines the debts of the individual members as follows:

<u>Member 1</u>

1^{st} Mortgage Loan on Home (secured)	\$100,000
Loan on F-150 Pickup Truck (secured)	\$28,000
Loan of LLC B (secured)	\$625,000

(The loan officer does not include all of LLC B's debt per Regulation No. 14, Section 6 b. (iii) since Member 1 owns less than 35% of LLC B, but does [per Regulation No. 14, Section 6 b. (iv)] include the amount of Member 1's limited guaranty of LLC B's debt.)

Loan of LLC C (unsecured) \$50,000

(The loan officer does not include all of LLC C's debt per Regulation No. 14, Section 6 b. (iii) since Member 1 owns less than 35% of LLC C, but does [per Regulation No. 14, Section 6 b. (iv)] include the amount of Member 1's limited guaranty of LLC C's debt.)

Total Debts of Member 1 to be aggregated:	\$50,000 (unsecured)
	\$803,000 (secured & unsecured)

<u>Members 2, 3, and 4 (same for each member):</u>

Loan of LLC B (secured) \$625,000

(The loan officer does not include all of LLC B's debt per Regulation No. 14, Section 6 b. (iii) since each member owns less than 35% of LLC B, but does [per Regulation No. 14, Section 6 b. (iv)] include the amount of each member's limited guaranty of LLC B's debt.)

Loan of LLC C (unsecured) \$50,000

(The loan officer does not include all of LLC B's debt per Regulation No. 14, Section 6 b. (iii) since each member owns less than 35% of LLC B, but does [per Regulation No. 14, Section 6 b. (iv)] include the amount of each member's limited guaranty of LLC B's debt.)

Debts (each) of Members 2, 3, and 4:	\$50,000 (unsecured)
	\$675,000 (secured & unsecured)

Analysis of Debts of Group as Associates

Debts of LLC B and LLC C

Had the loan officer, in Step 2, concluded that the members of LLC B and LLC B should be considered as a group and had he looked for common benefit, common repayment source, common purpose, and common control between LLC B and LLC A, the loan officer would have arrived at the following totals for the combined debts of the LLCs:

Loan of LLC B (secured)	**$1,950,000**
Loan of LLC C (unsecured)	**$150,000**
Total Debts for Credit Exposure Limit Purposes	**$2,100,000**

Step 4: The loan officer determines that none of the exceptions in §5-5A-22(d)(1)-(4) apply to these loans, and the collateral does not meet the requirements of Regulation No. 14, Section 4 for any of the loans to be considered as exceptions under 5-5A-22(d)(5) since it is not cash or equivalent to cash and does not have a readily established market value.

Step 5: Check the total of unsecured loans against the bank's 10% unsecured Credit Exposure Limit. The loan officer determines that none of the aggregated debts of the individual members exceed ABC Bank's $1,000,000 unsecured Credit Exposure Limit. The total unsecured aggregated debt of each member (from Step 3 above) is $50,000.

The loan officer does not consider the combined debts of LLC B and LLC C, but the amount of those unsecured debts is only $150,000 (representing the unsecured loan to LLC) and would not constitute a violation of the unsecured Credit Exposure Limit.

Step 6: Check the total of secured and unsecured loans against the bank's 20% total unsecured and secured Credit Exposure Limit.

The loan officer determines that the $803,000 total secured and unsecured aggregated debt of Member 1 and the individual aggregated secured and unsecured debts of Members 2, 3, and 4 at $675,000 each (arrived at in Step 3) do not exceed ABC Bank's secured and unsecured Credit Exposure Limit of $2,000,000. **The loan officer, however, by not concluding in Step 2, that the members of LLC B and LLC B should be considered as a group and by not looking for common benefit, common repayment source, common purpose, and common control between LLC B and LLC A, does not consider the proper $2,100,000 total of the combined secured and unsecured debts of LLC B and LLC C. Consequently, when the $150,000 loan to LLC C is closed and funded on March 5, 2013, it is a violation of ABC Bank's $2,000,000 secured and unsecured Credit Exposure Limit because it brings the combined debt to $2,100,000. Also, because the loan officer did not consider the aggregated debt to exceed 10% of ABC Bank's capital, he did not seek the approval of ABC Bank's loan committee as required by Alabama Banking Code Section 5-5A-22(b) and Regulation No. 14. Consequently, the failure to seek advance committee approval of the loan to LLC C violates §5-5A-22 and Regulation No. 14.**

<u>EXAMPLE 5 – Renewal and Additional Advance; Declining Capital Base; Responsibility for Informing</u>

On March 5, 2012, ABC Bank extended a $2,400,000 loan to Corporation Z for the purposes of working capital. The loan was collateralized by 10 acres of land plus improvements which consisted of a 35,000 square foot manufacturing facility having a total appraised value of $3,000,000. The note was set to mature on March 5, 2013. At the time (3-5-2012), the loan received all the proper approvals and was well within ABC Bank's 20% secured and unsecured Credit Exposure Limit which was $2,500,000 based on ABC Bank's capital of $12,500,000 reported on its 12-31-2011 Call Report.

Beginning with the first quarter of 2012 and over the remainder of 2012, ABC Bank's capital began to erode each quarter due to substantial loan losses unrelated to the subject borrower. Capital declined from $12,500,000 on 12-31-2011 to $12,000,000 on 3-31-2012, to $11,500,000 on 6-30-2012, to $11,000,000 on 9-30-2012 and finally to $10,000,000 as of 12-31-2012. Consequently, the combined secured and unsecured Credit Exposure Limit declined from $2,500,000 to $2,000,000 over the same period.

<u>Step 1</u>: Determine the borrower or group of borrowers whose debts should be looked at to determine if they should be aggregated. On March 1, 2013, the loan officer begins preparations to renew the $2,400,000 loan to Corporation Z by its maturity date of March 5, 2013. He knows that ABC Bank has no other loans to the principals of Corporation Z or their related interests. **However, since it is only a renewal and no new money is being advanced, he does not go through the process of evaluating the loan for compliance with Credit Exposure Limits.**

<u>Step 2</u>: Determine the debts of each borrower or the group of borrowers that need to be aggregated by looking at:

a. Common benefit from the loans,
b. Common repayment sources for the loans,
c. Common purpose for the loans,
d. Common control among the entities receiving the loans, and
e. Aggregation rules of §5-5A-22(c)(2)(a.-f.) and of Regulation No. 14, Section 6 b. (i.-viii.).

In Step 1, the loan officer determined that the renewal did not need to go through the evaluation process. Had he done so, he would have determined that there were no additional loans that needed to be looked at for aggregation purposes. Consequently, he did not go through the aggregation procedures in Step 2.

<u>Step 3</u>: Determine the proper amount of each loan to be counted for Credit Exposure Limit purposes (e.g., full amount of line of credit vs. amount drawn) and calculate the secured and unsecured totals of the aggregated loans (Refer to Regulation No. 14, Sections 1 g., 2, and 3).

Since the loan had been reviewed for Credit Exposure Limit purposes in 2010, the loan officer decided that it did not need to be reviewed again for compliance with the Credit Exposure Limits because the loan had subsequently paid down to $2,200,000. He also considered that the loan remained below the Credit Exposure Limit calculated at the time of the loan's origination and did not exceed the original loan amount made on March 5, 2012.

In reaching the above determination, the loan officer decided that the outstanding loan did not need to be considered for Credit Exposure Limit purposes; however, this was an error on his part. Section 1 g. of Regulation No. 14 defines a loan, in part, as a making or renewal of any loan, line of credit, or extension of credit. Consequently, the $2,400,000 amount of the loan to be renewed should have been evaluated and considered as a secured loan for Credit Exposure Limit purposes.

Step 4: The loan officer, had he evaluated the renewal properly for Credit Exposure Limit purposes would have determined that none of the exceptions in §5-5A-22(d)(1)-(4) applied to the renewal loan, and the collateral would not meet the requirements of Regulation No. 14, Section 4 for the renewal loan to be considered an exception under 5-5A-22(d)(5) since the collateral was not cash or equivalent to cash and did not have a readily established market value.

Step 5: Check the total of unsecured loans against the bank's 10% unsecured Credit Exposure Limit.

The loan officer, had he properly considered the renewal loan for Credit Exposure Limit purposes, would have considered it as secured for Credit Exposure Limit purposes and would not have measured it against ABC Bank's $1,000,000 unsecured lending limit.

Step 6: Check the total of secured and unsecured loans against the bank's 20% total unsecured and secured Credit Exposure Limit.

The loan officer, because he did not consider the renewal of the loan as an extension of credit for Credit Exposure Limit purposes, did not measure the renewal of the $2,400,000 loan against the bank's Credit Exposure Limit as of the proposed renewal date of March 5, 2013. Had he done so, he would have determined that, since the bank's capital had dropped significantly since 12-31-2011, the renewal of the loan at $2,400,000 would have been in excess of the bank's 20% secured and unsecured Credit Exposure Limit ($2,000,000) based on a calculation using the most recent 12-31-2012 Call Report. Regulation No. 14, Section 1 b. requires, in part, that the Capital Base for computing the maximum Credit Exposure Limit shall be the amounts shown for the required capital accounts (not detailed) including the allowance for loan and lease losses reflected on the bank's most recent quarterly Call Report. Since the loan was a renewal which is treated as a new extension of credit, the bank is in violation of Regulation No. 14.

The loan officer, after getting the loan renewal package approved by ABC Bank's Board, renewed the $2,400,000 loan on March 5, 2013 in violation of Section 5-5A-22 and Regulation No. 14.

ABC Bank, because renewals count for Credit Exposure Limit purposes, had only certain options for dealing with its decline in capital. Among those options, ABC Bank could have:

- When it saw its capital declining, ABC Bank could have elected to review all loans over 10% of capital or near its Credit Exposure Limit (including the $2,400,000 loan in this example) to determine which of those loans would require renewal during the period of declining capital, and it could have determined which of those loans could be prudently renewed for longer periods until the bank's capital recovered.
- It could have sought a participant bank in advance of the original maturity date to see if the loan could be renewed within the Credit Exposure Limit.

- In the case of lines of credit, it could evaluate actual usage of the lines and borrowing needs of the borrower and renew the loan at a lesser amount to comply with the Credit Exposure Limit.
- It could have asked the borrower to pay the loan down to an amount which ABC Bank could legally renew.

Responsibility for Informing

In the case of this loan, the examiners cited the bank for making the renewal of the loan that exceeded ABC Bank's secured and unsecured Credit Exposure Limit. They also cited the bank for violating Section 5 of Regulation No. 14 because it did not inform all affected personnel of the bank's declining Credit Exposure Limits. Even though he was not informed by bank management, the loan officer was still responsible, per Section 5 a. of Regulation No. 14, for ascertaining the proper Credit Exposure Limit.

EXAMPLE 6 – Tangible Economic Benefit and Common Repayment Source, Other Indications of Responsibility

As of February 5, 2013, Individual Borrower X and his wholly owned companies, X Corporation and LLC Y, were indebted to the bank in an aggregate amount of $1,900,000 on loans made in January of 2012 with two-year maturities and monthly interest payments. All of the loans to Borrower X, X Corporation, and LLC Y are secured. Also, as of February 5, 2013, there were five unsecured loans of $100,000 each outstanding to investors in LLC Y. Memos in ABC Bank's files indicated that these five loans were made for the purpose of investing in the companies of Borrower X and were to be repaid from profits from the sale of real estate (the business of Corporation X and LLC Y). Each of these five unsecured loans was made for a one-year maturity with monthly interest payments. The five loans had various maturity dates between February 5, 2013 and March 5, 2013. All were renewed at maturity during this period.

From February 5, 2013 until March 5, 2013, four new $100,000 unsecured loan requests from employees of Corporation X were received, closed, and funded. These employees stated that the purpose of each of the four loans was real estate investment.

On June 7, 2013, examiners began an examination of ABC Bank. In reviewing the bank's loan files, they noted the loans to Individual Borrower X and his wholly owned companies. They also noted the loans that had been made to investors in those companies and to employees of the companies. They determined that they should go through the process of looking at all loans related to Individual Borrower X for Credit Exposure Limit purposes.

Step 1: Determine the borrower or group of borrowers whose debts should be looked at to determine if they should be aggregated.

As noted above, the examiners decided to look at all of the loans to Individual Borrower X, Corporation X, LLC Y, all of the investors in those businesses, and all of the employees of those businesses to determine which, if any, should be aggregated for Credit Exposure Limit purposes.

Step 2: Determine the debts of each borrower or the group of borrowers that need to be aggregated by looking at:

a. Common benefit from the loans,
b. Common repayment sources for the loans,
c. Common purpose for the loans,
d. Common control among the entities receiving the loans, and
e. Aggregation rules of §5-5A-22(c)(2)(a.-f.) and of Regulation No. 14, Section 6 b. (i.-viii.).

The examiners determined that the loans to Individual Borrower X, Corporation X, and LLC Y should be combined as follows:

Individual Borrower X	$400,000 (secured by real estate)
Corporation X	$1,000,000 (secured by real estate)
LLC Y	$500,000 (secured by real estate)
Subtotal	$1,900,000 (all secured)

The examiners determined that Individual Borrower X, as 100% owner of Corporation X and LLC Y, received benefit from all of the above loans, and that he exercises common control of Corporation X and LLC Y by virtue of his ownership percentage. They also determined, according to Section 5-5A-22(c)(2)(b. and d.) and Sections 6 b. i. and 6 b. iii. of Regulation No. 14 that these loans should be aggregated. The Code sections state: (1) "In computing the total liabilities of any person to a bank, there shall be included… any loans made to, or for the benefit of, a corporation of which such person owns 35 percent or more of the capital." and (2) "In computing the total liabilities of any corporation to a bank, there shall be included all loans made for the benefit of the corporation, and all loans to, or for the benefit of any partnership or unincorporated association, or any member thereof, who owns 35 percent or more of the capital of such corporation."

The examiners then looked at the loans to the investors in LLC Y and employees of Corporation X. They determined that the proceeds of each of the five $100,000 unsecured loans to the investors were put into LLC Y. Each loan was to be repaid from notes executed from LLC Y to the individual investors. Consequently, the examiners determined that these loans represented common benefit to LLC Y and, because of this common benefit, should be aggregated with the loans to LLC Y, Corporation X, and Individual Borrower X.

In looking at the four loans to the employees of Corporation X, the examiners, after speaking with loan department personnel, were told that Individual Borrower X was making the monthly interest payments on these four employee loans as well as on the five loans to the investors in LLC Y. All payments were made with checks written on accounts of Corporation X that were signed by Individual Borrower X. The examiners, therefore, concluded that all nine of the $100,000 loans to investors and employees of Individual Borrower X's companies were dependent upon the same repayment source and should be aggregated. The examiners then determined that all of the proceeds of the four employee loans had gone into Corporation X's accounts. Further questioning of the loan officer by examiners revealed that the loan officer was aware that the payments on the nine unsecured loans were being made by Individual Borrower X.

In looking at common purpose of the nine loans, the examiners felt that they were made for the same ultimate purpose of furthering the businesses of Individual Borrower X, but they did not cite common purpose due to the differing real estate projects.

In looking at common control, it was clear to the examiners that Individual Borrower X certainly controlled the companies responsible for repayment of the loans; however, due to the loans being in the names of individual borrowers, the examiners did not cite common control as a reason for aggregation.

In looking at the aggregation rules of §5-5A-22(c)(2)(a.-f.) and of Regulation No. 14, Section 6 b. (i.-viii.); the examiners, as with the loans to Corporation X and LLC Y, also consulted with the Superintendent and determined, according to Sections 5-5A-22(c)(2)(b. and d.) and Sections 6 b. i., 6 b. iii. and 6 b. viii. of Regulation No. 14, that these loans should be aggregated. They cited Regulation No. 14, Section 6 b. viii. that states "When, in the opinion of the Superintendent, a Person appears to be fully responsible for the debt service on loans that are purported to be 'without recourse' through the practice of paying off delinquent loans or other indications of responsibility, then the amount of such loans will be aggregated and treated as one loan to the Person."

Consequently, the examiners determined the aggregated totals of the debts as follows:

Individual Borrower X	$400,000	(secured by real estate)
Corporation X	$1,000,000	(secured by real estate)
LLC Y	$500,000	(secured by real estate)
Subtotal	$1,900,000	(all secured)
Five Loans to Investors in LLC Y	$500,000	(unsecured)
Four loans to employees of Corporation X	$400,000	(unsecured)
Subtotal	$900,000	(all unsecured)
Total secured and unsecured	$2,800,000	

Step 3: Determine the proper amount of each loan to be counted for Credit Exposure Limit purposes (e.g., full amount of line of credit vs. amount drawn) and calculate the secured and unsecured totals of the aggregated loans (Refer to Regulation No. 14, Sections 1 g., 2, and 3).

The examiners determined that all of the loans made and renewed would be counted in their entire amounts for Credit Exposure Limit purposes. (See Step 2 above.)

Step 4: The examiners determined that none of the exceptions in §5-5A-22(d)(1)-(4) applied to the loans, and none of the collateral would meet the requirements of Regulation No. 14, Section 4 for any of the loans to be considered as exceptions under 5-5A-22(d)(5) since the collateral was not cash or equivalent to cash and did not have a readily established market value.

Step 5: Check the total of unsecured loans against the bank's 10% unsecured Credit Exposure Limit.

The examiners looked at all nine of the $100,000 unsecured loans that were made or renewed between February 5, 2013 and March 5, 2013. They determined that the total of those unsecured loans did not exceed ABC Bank's $1,000,000 unsecured Credit Exposure Limit.

Step 6: Check the total of secured and unsecured loans against the bank's 20% total unsecured and secured Credit Exposure Limit.

As noted in Example 5, ABC Bank's capital declined from $12,500,000 on 12-31-2011, to $12,000,000 on 3-31-12, to $11,500,000 on 6-30-2012, to $11,000,000 on 9-30-2012 and finally to $10,000,000 as of 12-31-2012. Consequently, the combined secured and unsecured Credit Exposure Limit declined from $2,500,000 to $2,000,000 over the same period.

The $1,900,000 in secured loans to Individual Borrower X, Corporation X and LLC Y were made in January 2012 when the bank's secured and unsecured Credit Exposure Limit was $2,500,000. Consequently, those loans were not considered violations of the Credit Exposure Limits.

The five $100,000 loans to the Investors in LLC Y were originally made between February 5 and March 5 of 2012. When added to the debts of Individual Borrower X, Corporation X, and LLC Y, these loans brought the aggregated debt to $2,400,000. Consequently, the original making of these five loans was not in violation of ABC Bank's $2,500,000 Credit Exposure Limit at the time of origination.

These five $100,000 loans to investors in LLC Y were, however, renewed between February 5, 2013 and March 5, 2013, and the four $100,000 loans were made to employees of Corporation X during that same time period during which ABC Bank's secured and unsecured Credit Exposure Limit had dropped to $2,000,000. The loans were made and renewed as follows:

Loans to Individual Borrower X, Corporation X, and LLC Y (made January 2012)	$1,900,000 (not violations)
Loan to Investor A (renewed February 5, 2013)	$100,000 (not violation)
Loan to Investor B (renewed February 6, 2013)	**$100,000 (violation[3])**
Loan to Employee F (made February 6, 2013)	**$100,000 (violation)**
Loan to Employee G (made February 7, 2013)	**$100,000 (violation)**
Loan to Investor C (renewed February 12, 2013)	**$100,000 (violation)**
Loan to Investor D (renewed February 20, 2013)	**$100,000 (violation)**
Loan to Employee H (made February 21, 2013)	**$100,000 (violation)**
Loan to Investor E (renewed March 5, 2013)	**$100,000 (violation)**
Loan to Employee I (made March 5, 2013)	**$100,000 (violation)**

[3] It is important to note that the entire, aggregated lending relationship is not considered a violation. The violations of §5-5A-22 and Regulation No. 14 were the acts of making or renewing the eight loans from February 6, 2013 through March 5, 2013 in excess of ABC Bank's $2,000,000 secured and unsecured lending limit.