TEXAS BANK REPORT

Texas Department of Banking, Commissioner, Charles G. Cooper Data as of September 30, 2012

Commissioner's Comments

As we prepare this edition of the Texas Banking Report for publication, the 83rd Legislative Session has begun. Many of you may not be aware of the added responsibilities and opportunities state agencies have during the legislative process. Months before the session begins, agency staff accumulates ideas for improving our regulatory system. We look for opportunities to reduce regulatory burden and explore alternatives to enhance our operational efficiencies. Changes in federal rules and regulations along with industry changes stemming from new technologies and/or shifts in industry preferences are thoroughly considered. These ideas come from staff, our regulated entities and consumer groups. For example, perpetual care cemetery operators seek relief from outdated platting requirements, and corporate applicants have asked that we conform the terms of the Finance Code with the Business Organizations Code. The agency's legal staff drafted legislative recommendations for these two items as well as numerous other changes agreed to by the agency, the regulated community and consumer groups. A listing of recommended banking legislation is included in this issue.

After vetting all the ideas through the Finance Commission, we will meet with key members of the appropriate House and Senate committees to brief them on the recommendations. In many cases these recommendations become filed bills. We are then tasked with discussing these recommendations with all members of the committees, answering their questions and addressing their concerns. Further, we are frequently asked to meet with legislative members and their staff to brief them on current issues affecting our regulated entities, to update them on our activities in general, to explain how a bill will affect our regulated entities, or to provide resource testimony at committee hearings.

On a grander scale, the Department also monitors all legislative filings daily and tracks specific bills that may affect one of our regulated entities, department staff, or department operations. In the heat of the session, this can easily be fifty plus bills a day. The goal is to be informed so we can answer your questions, be a reliable resource to our elected officials, and not be surprised at the end of the session.

The legislative session is like a roller coaster ride with many loops and unexpected turns, but if we do our job properly, we will help ensure we have more effective and efficient regulation as we coast to the end with our arms held high.

Charles G. Cooper
Banking Commissioner

Investment Analysis and Supervision Without the Use of External Ratings

Gary May

Section 939A of the Dodd Frank Act directed federal banking regulatory agencies to remove all references to the use of investment ratings provided by the Nationally Recognized Statistical Rating Organizations (NRSROs) from their regulations regarding the assessment of credit-worthiness and to "substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate". In response to this directive, the Office of the Comptroller of the Currency (OCC) issued Bulletin 2012-18, on June 26, 2012, with its accompanying guidance for implementation. In turn, the Federal Reserve issued SR 12-15 on November 15, 2012, while the FDIC issued FIL-48-2012 on November 16, 2012. The FDIC and FRB issuances echoed the OCC's guidance, and explicitly included it by reference. These directives all revised the relevant laws and regulations for each agency addressing investment quality, and also provided guidance for appropriate ongoing supervision of investment portfolios. In each case, the effective date of the new regulatory guidance was January 1, 2013.

Although Section 939A did not affect or require changes in state law, the change in federal policy affects state banks. The consensus guidance of all three federal regulators addresses several major points:

- **New definition of "investment grade"**: This term no longer refers to any specific external rating grade, but instead describes a security "where the issuer has an adequate capacity to meet the financial commitments under the security for the projected life of the investment". "Adequate capacity" exists where "the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected".

- **Pre-purchase analysis:** Banks will be expected to perform adequate pre-purchase credit analysis. Without such documented analysis, the bank cannot demonstrate that it has determined the permissibility of the security as a bank investment.

- **Ongoing Supervision:**

o Appropriate ongoing reviews of investment portfolios should be performed to verify that safety and soundness requirements are met, relative to the institution's risk profile and the size and complexity of its portfolio. This means that credit quality is to be assessed not only at the time of purchase, but on a recurring basis thereafter.

o Material positions and concentrations should be subject to limits and monitored more frequently.

o More complex securities should be subject to meaningful stress-test scenarios.

o The overall portfolio should have risk assessment and reporting processes that will inform the Board in a timely fashion whenever material changes in risk profile have occurred, so that prompt action may be taken when needed.

o Adequate policies and procedures must be in place to reflect the bank's risk appetite, and to provide sufficient supervision within the overall framework of the bank on an ongoing basis.

o Failure to properly supervise the investment portfolio may be considered an unsafe and unsound practice.

The guidance stresses that neither the basic principles of sound portfolio management, nor of credit analysis - character, capacity, collateral, covenants - have been changed from long-standing regulatory standards. Likewise, banks are still expected to consider the interest rate, liquidity, price, foreign exchange, transaction, compliance, strategic, and reputational risks for each bond, as well as its overall appropriateness for the particular bank.

The OCC's guidance included a grid that laid out in general terms the factors that could be assessed for different broad categories of bonds – corporates, municipal GOs, municipal revenue, and structured securities (such as asset-backed bonds (ABS), or collateralized mortgage obligations (CMOs)). Not all bonds are subject equally to the new analysis guidelines. Type 1 securities [U.S. Treasury and Agency issues and municipal general obligations (GOs)] are exempt. For those banks that are well-capitalized, municipal revenue issues are similarly exempt. However, the new regulatory guidance points out that material credit analysis is still prudent for municipal GO and revenue issues, for all banks. In addition, the degree of suggested analysis necessary for differing bond types varies widely; corporates, for example, generally have a less-complex analysis process than structured products.

Banks may choose to perform the necessary credit analyses internally, or to rely on third–party analysis and data. In the latter case, it is important to note that ultimate responsibility for all decisions made rests with management and the Board, and that it is the bank's responsibility to ensure that any outside third parties used are independent, reliable, and qualified. External ratings – like those from Moody's, Standard & Poor's, and Fitch – may still be considered in the evaluation process, but may not be the sole determinant of whether a security is deemed to be of investment grade.

The new guidance replaces the former 'bright lines' of external ratings with a more judgmental assessment of credit quality, wherein the risk of default is "low", but not quantitatively defined. In essence, all covered securities are now to be analyzed and documented as though they were non-rated issues. A bank's documented analysis of pertinent credit factors, backed by the underlying data, must support the bank's decision. Likewise, there is some leeway in the frequency with which bonds of differing types and credit strengths will need to be reviewed after purchase. As of January 1, 2013, when the new guidance became effective, all applicable bonds held by a bank should have adequately documented credit analyses in file to support their permissibility as bank investments.

Internal regulatory processes are also in a state of transition.

• The existing FFIEC guidance on the classification of securities, as set forth in FDIC FIL 70-2004 and FRB SR 04-09, has not yet been updated to reflect the new post-Dodd Frank Act guidance. It still refers explicitly to external ratings as the primary determinant of whether a security is classified or not. Updates to these guidelines are expected fairly soon.

• Examination procedures that encompass these new expectations are also in process at each of the Federal regulators.

• The Texas Department of Banking is waiting to review both the updated FFIEC guidelines for the classification of securities and any new federal examination procedures for investments, before reviewing its existing standards and examination procedures. In the meantime, the Department will examine for compliance with the existing federal guidance.

For more information or questions, please contact Gary May at 512-475-1375 or gary.may@dob.texas.gov.

Why IT Security Has Changed for Executive Officers

Phillip Hinkle

During the latter part of 2012, three large cyber thefts occurred at small community banks. One theft was approximately a quarter million dollars, another $1.7 million, and the third $6 million. In all three incidents, multiple employees at each bank had been trained on Corporate Account Takeover (CATO) risks, but failed to follow procedures or observe very obvious indications that a wire was fraudulent. In response to this pattern of financial losses, Commissioner Cooper released Industry Notice IN2013-03 addressing Executive Oversight of Cyber-Crime Risks in November 2012.

Traditionally, the banking career of most Executive Officers' has been built on the credit side of the bank; because that is where most of the financial risk has historically occurred. But there are growing operational risks, in particular cyber-fraud risk. In the case of the $1.7 million loss and in the other banks where cyber fraud losses have occurred, the damage would be similar to an approximate 2.5% credit loss for the year. And, there is no loan loss reserve to cushion the impact on earnings.

It is easy for a bank to get a false impression that these thefts are not a risk to them, especially if the executive officers have not communicated with someone who has experienced a theft. Cyber-crimes are continuing to occur and they represent a risk to all banks. Last year demonstrated that cyber thefts are not diminishing or going away, rather they are on the rise.

This changing risk environment for banks requires adaptation for Executive Officers. Information Technology is no longer just a back office operational activity. Unfortunately, human nature is to work in our "comfort zone" and to focus on those areas we know best. If our daily "to-do list" is long, we often leave the tasks that we are the least comfortable with for another day, whenever that day may come.

Bank staff and the Board should be receiving periodic briefings throughout the year regarding the changing threats and mitigation strategies. Cyber fraud changes frequently, so the fraud threats must be discussed regularly. Strive to build a culture of information security that encourages employees to take ownership of their role in reducing / preventing electronic thefts. Compliance with information security guidance and regulations is only half the battle. The financial risks of banking have evolved and Executive Officers need to be helping guide their organization into this new environment.

State-chartered banks and trust companies having questions regarding IT security issues may contact Phillip Hinkle, Chief IT Security Examiner, (817) 640-4050.

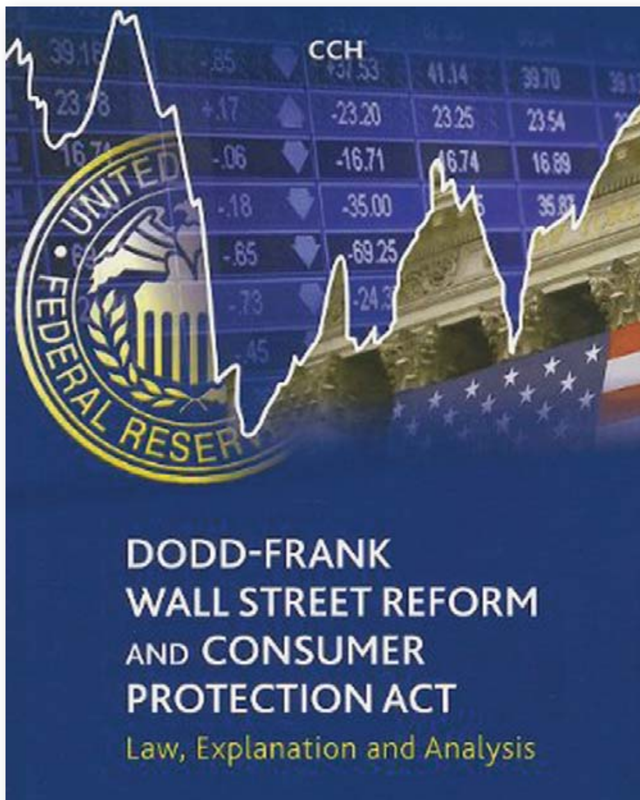
Lending Limits Applied to Derivative Transactions

Everette Jobe and Gary May

Effective January 21, 2013, Section 611 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) prohibits state-chartered banks from engaging in derivative transactions unless "the law with respect to lending limits of the State in which the insured State bank is chartered takes into consideration credit exposure to derivative transactions." To meet this new requirement, the Department's rules governing lending limits for state banks have now been amended to include credit exposures arising from derivative transactions and securities financing transactions (securities repurchase agreements, reverse repurchase agreements, securities lending transactions and securities borrowing transactions).

Because the rule is purposefully designed to be similar to the rule applicable to national banks, the Department intends to seek amendments to its rules to conform them to additional revisions that the Office of the Comptroller of the Currency (OCC) is anticipated to announce within the next few months. The Department's rules provide a temporary exception for compliance until May 1, 2013, a date that will likely be extended to permit further modification of the methods by which credit exposures are calculated. The OCC also recently announced formal enforcement of its rule would be delayed until July 1, 2013.

Other than adding necessary definitions and making conforming changes throughout the rules, the actual limits on derivative transactions and securities financing transactions are contained in one new rule, 7 TAC §12.12. This article will focus on application of the lending limits to derivative activities commonly undertaken by state banks, primarily through a few simple examples. A more comprehensive summary of the manner in which this rule operates is available in the adoption preamble published in the Texas Register. A number of other examples are also available in an explanatory table, but please be aware that reviewing examples, whether in this article or in the explanatory table, is not a substitute for reviewing adopted §12.12 itself.



For state banks in Texas with derivative activities, the most frequent sources of credit exposures are forward sales of mortgages to investors, and hedging interest rate risk or commodity risk for loan customers. For a smaller number of banks, credit exposures will arise from hedging their own balance sheets, engaging in foreign exchange forwards, and embedding credit derivatives in large commercial loans.

The term "credit exposure" is used to describe the amount of credit risk from derivative transactions that must be aggregated and compared with the lending limit with respect to each counterparty. Section 12.12 sets forth three approaches to determining the amount of credit exposure. Those banks with proprietary computer models for derivative valuation that have been approved for use under applicable federal capital rules will be allowed to use those, and also to net out their exposures to counterparties. The great majority of banks are much more likely to make use of the other two available alternatives, which feature simple grid pricing approaches, based primarily on the type of derivative and its contractual term. These two matrix-based approaches are captured below. The Conversion Factor Matrix Method (CFM) and the Remaining Maturity Matrix Method (RMM). (In the case of credit derivatives, a special rule applies in Section 12.12(b)(2), requiring a bank to calculate the counterparty credit exposure by adding the net notional value of all protection purchased from the counterparty on each reference entity. For further explanation, see the adoption discussion in the Texas Register.) The following paragraphs illustrate the application of the CFM and RMM approaches to some common derivative transactions.

The CFM approach 7 TAC

Conversion Factor Matrix for Calculating Potential Future Credit Exposure

Original maturity	Interest Rate	Foreign exchange rate and gold	Equity	Other (includes commodities and precious metals except gold)
1 year or less	.015	.015	.20	.06
Over 1 to 3 years	.03	.03	.20	.18
Over 3 to 5 years	.06	.06	.20	.30
Over 5 to 10 years	.12	.12	.20	.60
Over 10 years	.30	.30	.20	1.0

§12.12(b)(1)(B) establishes the credit exposure one time only, at inception. Examples:

- A $1 million mortgage forward sale would be considered an interest rate derivative, with a maturity of less than one year, and would therefore receive a weight of 0.015 or 1.5%, for a credit exposure of $15,000.

- Credit exposure could add up much faster on longer term derivatives, especially with respect to commodities. For example, the CFM factor for a commodities derivative with a six-year term is .60, or 60% of the transaction amount.

The RMM approach 7 TAC

Remaining Maturity Factor for Calculating Credit Exposure

	Interest Rate	Foreign exchange rate and gold	Equity	Other (includes commodities and precious metals except gold)
Multiplicative Factor	1.5%	1.5%	6%	6%

§12.12(b)(1)(C) requires more ongoing monitoring than the CFM method, but will generally result in a much lower calculated credit exposure. The RMM methodology calculates credit exposure as the greater of zero; or, the sum of the current mark-to-market value of the derivative transaction, plus the product of (the notional amount of the transaction) X (the remaining maturity in years of the transaction) X (a fixed multiplicative factor) determined by reference to the RMM table. Examples:

- A $1 million mortgage forward sale with a 30-day maturity would be considered an interest rate derivative. Its credit exposure would be calculated as ($1,000,000) X (1/12) X (1.5%), or $1,250.

- The same $1 million mortgage forward, with the same 30-day maturity, would have a negative market value of, say, ($10,000) if mortgage rates had risen by 25 basis points. Since this is greater than the product of ($1,000,000) X (1/12) X (1.5%), or $1, 250, the credit exposure is considered to be zero.

- The same $1 million mortgage forward, with the same 30-day maturity, would have a positive market value of, say, $10,000 if mortgage rates had fallen by 25 basis points. Since this gain is 'at risk' from the counterparty, it is added to the product of ($1,000,000) X (1/12) X (1.5%) = $1, 250, for a total credit exposure of $11,250.

What You Should Take Away

The key concern for banks should be how to ensure that credit exposure arising from all transactions with a single counterparty are aggregated for legal lending limit purposes. These could include hedging and forward sales of mortgages, foreign exchange transactions, hedging the bank's own balance sheet or debt instruments, and hedging interest rate and commodity risks for customers. To the extent that any of these activities arise in different departments of the bank, the bank must develop a mechanism for collecting and aggregating the information by counterparty. Cumulative exposures to upstream counterparties with whom master derivatives agreements are in place should be similarly monitored.

For more information, please contact Gary May at 512-475-1375 or gary.may@dob.texas.gov.

Texas Department of Banking
Proposed Legislative Recommendations
2013 Session

Banks and Trust Companies

- change limits for investment in trust company fixed assets from 60% to 100% of restricted capital
- change requirements for monthly board of directors meetings to give Commissioner discretion to allow meetings less often
- expand subpoena power to assist the examination or investigation function
- clarify that advisory directors are not entitled to confidential regulatory information unless contractually bound by confidentiality agreement
- revise standard for removal or prohibition to "best interest of public," from "best interest of the bank or trust company involved"
- add "appointment of new officers and directors or removal of current officers and directors" to list of actions that require prior approval for an entity under a supervision order
- revise interstate merger, branching, and host state authority to be consistent with federal statutes
- revise loan production office requirements and disposal period for certain OREO to establish parity with national banks
- add definition of "surplus" in Trust Company Act
- change terminology regarding permissible royalty interests to be consistent with Texas oil and gas law
- correct references

Conforming Amendments

- revise terms in Title 3, Subtitles A, F, and G of the Finance Code to be consistent with the Business Organizations Code (e.g., "articles of association" to "certificate of formation")

Ownership of Royalty Interests

Everette Jobe

Authority of banks to invest in real estate is severely limited. Other than investment in bank facilities, banks generally acquire other real estate only through collection of loans, such as instances where the real estate was pledged to secure a loan subsequently in default or, in statutory language, only "as necessary to avoid or minimize a loss on a loan or investment previously made in good faith." Such "Other Real Estate Owned" (OREO) must be disposed of promptly, subject to certain exceptions, but generally no later than 10 years after its acquisition.

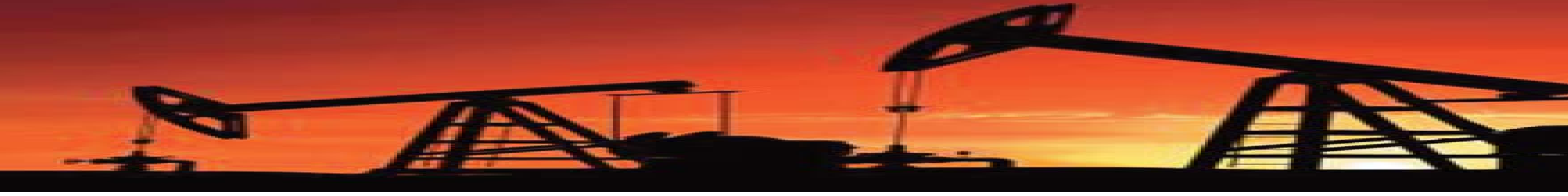
Subsurface rights are generally classified by law throughout the United States as real property interests and, as such, are subject to the OREO limitations. However, foreclosed property in the form of a mineral or royalty interest presents unique issues. If the minerals are not being produced, or if the revenues generated are merely nominal and sporadic, the subsurface rights have little or no value. Often such an interest cannot be sold because there are no willing buyers in the market, or if it can be sold, the price is seldom more than a nominal amount. A number of banks in Texas continue to hold OREO comprised of mineral or royalty interests originally acquired through foreclosure several decades ago. In such an instance, both state and federal law demand that the bank dispose of the property as previously described.

This article focuses on ownership of subsurface rights. Because of heightened interest in developing formerly marginal oil or gas formations, the Department of Banking has observed an increase in the number of banks actively seeking to generate ownership of mineral rights, and most have taken the wrong approach. For OREO comprised of subsurface rights, sale is still the first option, but other means of disposal are available.

Disposal of OREO to a Passive Real Estate Investment Subsidiary

The Federal Deposit Insurance Corporation (FDIC) has provided one means for a state bank to "dispose" of OREO for which there is no market, including a mineral or royalty interest, through transfer to a majority-owned, passive real estate investment subsidiary, thereby retaining indirect ownership, a method that exceeds the powers of a national bank. If a bank (and its subsidiary) meet the core eligibility requirements of 12 C.F.R. §362.4(c), it can transfer OREO to a qualifying subsidiary under 12 C.F.R. §362.4(b)(5)(i) after filing a notice with the FDIC that is processed without objection. The FDIC does not need to consent because it already has, by creating this exception. A notice for a §362.4(b)(5) activity will normally receive expedited processing, and "is deemed approved 30 days after receipt of a complete notice by the FDIC (subject to extension for an additional 15 days upon written notice to the bank) or on such earlier date authorized by the FDIC in writing."

Further, if a bank does not qualify for the §362.4(b)(5)(i) exception for some reason other than failure to meet applicable capital standards, the bank can still apply to the FDIC under 12 C.F.R. §362.4(b)(1) for



prior written consent to transfer OREO to a passive real estate investment subsidiary, as described in the exception.

Nonpossessory Royalty Interest

Setting up this special purpose, passive real estate investment subsidiary can be cost-prohibitive for OREO with little or no value. With respect to a limited type of royalty interest, use of a subsidiary can be avoided. A qualifying, nonparticipating royalty interest, as described below, can be retained by the bank because it is no longer OREO.

In 2007, the Department sought legislation to ease the difficulty of holding mineral or royalty interests, resulting in the enactment of Texas Finance Code §34.004. That section permits a limited category of royalty interests to be converted from "real estate" to "personal property" for banking law purposes, and retained in the bank. This provision of state law is narrower than it might first appear, in part because it must be interpreted consistent with limitations imposed by federal law. Only a small number of applications have been approved because the type of interest that will qualify is relatively rare. Further, even if the Banking Commissioner approves an application under Finance Code §34.004, the bank must still apply to the FDIC for permission to retain ownership of the interest in the bank, because continued ownership of the interest would exceed the powers of a national bank. However, the FDIC is aware of Finance Code §34.004 and the type of royalty interest it addresses, and in a typical case will approve continued ownership if already approved by the Banking Commissioner.

Texas Finance Code §34.004(a) by its terms applies to "nonworking mineral or royalty interests," an imprecise choice of words. The required standards for eligibility and approval, particularly §34.004(a)(2) (the interest must not be subject to expenses of exploration, development, production, operation, maintenance, or abandonment), make clear that an eligible interest must be a nonparticipating royalty that merely entitles the owner to a share of production under a lease free of exploration and production expenses. A nonparticipating royalty is **nonpossessory** in that it does not entitle the owner to produce the minerals, join in a lease of the mineral estate, or share in any bonus or delay rentals that might be paid under a lease, and merely entitles the owner to a share of production free of any of the expenses or costs of exploration, development, and production. Contractual indemnity is not an acceptable means of avoiding liability; the inherent nature of the real estate interest itself as recorded in the real property records must meet the criteria.

The language used in deeds to grant or reserve mineral rights can vary widely, so there are no magic words to look for. Instead, the **effect** of the language used has to be evaluated. A reservation of a fractional interest in minerals in place under the ground will incur production costs because the minerals must be found and produced, and is therefore impermissible. An interest in minerals after production is a nonparticipating royalty interest that won't bear the expense of production because the interest doesn't attach until after extraction or production.

Also note that if the interest is not a possessory interest in the minerals in place, the owner does not have sufficient ownership rights to sign a lease. That's why the application form asks whether the bank has been asked to sign a lease. If the bank signed a lease, or has the authority to sign a lease, the interest won't qualify. The application form also asks whether the bank has ever received a bonus or lease payment other than a royalty payment, because such payments indicate that the interest won't qualify.

Examples:

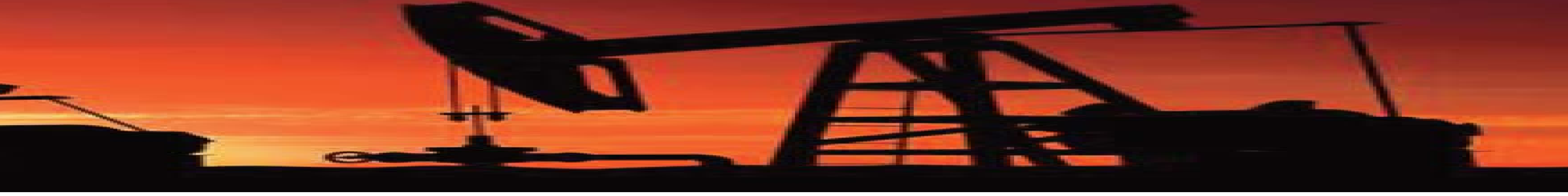
- The bank retains unto itself a 1/2 interest in the undivided minerals in and under said land **[not eligible]**

- The bank reserves unto itself, its successors and assigns, a one-thirty-second interest in all oil, gas, sulphur or other minerals, or their derivatives, that may be produced and saved from said premises. **[eligible]**

- Grantor reserves all of Grantor's interest in oil, gas and other minerals in and under and that may be produced from the Property. **[not eligible]**

To demonstrate the enormous variability that can occur in a grant or reservation clause and the need to carefully analyze the language for its effect, the following clause was the subject of a lawsuit that ultimately determined the clause created an nonpossessory interest. The description begins in a manner suggesting that the interest is ineligible, but then takes away all the ineligible parts:

- Grantor expressly reserves unto itself, its successors and assigns, a one-fourth royalty in all oil, gas and other minerals in and under or hereafter produced from the above-



described land; provided, however, that

(a) Grantor, its successors or assigns, shall never have a right to enter upon said land to drill for or develop said royalty, and

(b) Such reserved royalty shall be and stand subordinated to any and all valid liens hereafter placed, fixed or reserved on said land or any part thereof by Grantee, its successors or assigns, including in said liens the power of sale in any Deed of Trust which may be given as additional security for any indebtedness secured by any of the liens mentioned in this paragraph, and

(c) Said royalty is reserved for a term of forty-nine (49) years, and at the expiration of such term shall automatically terminate, and

(d) Such royalty shall be non-participating, in the sense that it shall not be necessary for the Grantor, its successors or assigns, to join in the execution of any oil, gas and mineral lease which Grantee, its successors or assigns, may elect to execute covering said premises or any part thereof, nor shall Grantor, its successors or assigns, participate in any bonus received for the execution of any such lease, nor in any rentals paid by virtue of the terms of any such lease, but if oil, gas or other minerals be produced in commercial quantities, then Grantor, its successors or assigns, shall, during the term of the existence of such reserved royalty, have and receive one-fourth part of such oil, gas and other minerals so produced as a royalty.

Signing a Mineral Lease

The Department is aware of several banks that have signed mineral lease contracts pertaining to OREO in the bank's portfolio, then applied for permission to retain the subsurface rights pursuant to Finance Code §34.004. Each such application has been denied because the interest does not qualify under that section. (As previously described, a qualifying interest under §34.004

does not include the executive right to sign a lease.) The interest subject to the lease thus remains OREO subject to an obligation to dispose of the property. Transferring to a qualified subsidiary may be the only option to retain the interest.

A bank that has signed a mineral lease on OREO should be aware that the FDIC views this leasing transaction as the "activation" of an impermissible investment and a violation of federal law. The FDIC considers a mineral lease by its nature to be a long-term transaction and relationship, and execution of the lease by a bank to be inconsistent with its obligation to dispose of OREO. To resolve the difficulty created, the bank must take steps to file an appropriate application with the FDIC under 12 C.F.R. Part 362. The following paragraphs describe the FDIC's requirements in this scenario.

With respect to a property that is subject to an existing oil, gas, & mineral lease which the bank has entered into, or for a property on which the bank intends to enter into an oil, gas, & mineral lease, the FDIC must fully assess the risk of the proposed activity to the insurance fund. Therefore, in addition to the basic information required in an application, the bank must provide, to the extent possible, the following information to the FDIC regarding its mineral interests on each of such properties that the bank wishes to transfer into a subsidiary:

1. Copies of all applicable oil or gas leases;
2. Copies of financial statements on the lessees of all oil or gas leases;
3. Information regarding all such lessees' history with federal and state regulators;
4. Copies of any insurance policies held by the bank and the subsidiary providing coverage on the bank's mineral rights;
5. Copies of any insurance policies held by any lessees providing coverage for the drilling operations on the mineral rights in question;
6. Information regarding any steps taken by any lessees regarding the mitigation of the risk of a substan-

tial spill;
7. Copies of relevant state and federal permits;
8. Copies of relevant state and federal inspection information for the past three years; and
9. Information regarding any cleanup requirements under state law.

In addition, because the FDIC must verify that all mineral interests held by the bank for investment purposes will be held in a properly insulated subsidiary, the bank's application will need to address the following factors that courts typically review in order to determine whether or not to pierce the corporate veil between a parent corporation and its subsidiary:

1. Whether subsidiary has sufficient operating capital in light of the normal obligations that are reasonably foreseeable for a business of its size and character within the industry;
2. Whether subsidiary is physically separate and distinct in its operations from the operations of the bank;
3. Whether subsidiary maintains separate accounting and other business records;
4. Whether subsidiary observes separate business entity formalities such as separate board of directors' meetings;
5. Whether subsidiary has a chief executive officer who is not an employee of the bank;
6. Whether subsidiary has a majority of its board of directors who are neither directors nor executive officers of the bank;
7. Whether subsidiary conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers that the subsidiary is a separate organization from the bank and that the bank is not responsible for and does not guarantee the obligations of subsidiary;
8. Whether subsidiary has a current written business plan that is appropriate to the type and scope of its business;
9. Whether subsidiary has qualified management and employees for the type of activity contemplated;
10. Whether subsidiary has policies and procedures to ensure adequate computer, audit and accounting systems, internal risk management controls, and has necessary operational and managerial infrastructure to implement the business plan;
11. Whether subsidiary issued stock certificates;
12. Whether subsidiary is referred to as "department" or "division" in the records of the bank;
13. Whether the bank and subsidiary maintain arms-length relationships in their transactions with one another or with any related entities; and
14. Whether subsidiary has only one business purpose.

Conclusion

Texas Finance Code §34.004 has limited applicability that a majority of applicants to date have failed to appreciate. Before voluntarily creating a retained mineral or royalty interest, such as by reserving the right in a deed conveying OREO to a buyer, a bank should consult an attorney well-versed in oil and gas law and notify the Department and the FDIC of its intentions.

Fundamentally, the business of banking does not include real estate investment activities or activities to develop and produce minerals from real estate. For that reason, a state bank as its first option should sell any subsurface rights that it acquires as OREO. The cited provisions of 12 C.F.R. Part 362 relating to use of a passive real estate investment subsidiary, as well as Texas Finance Code §34.004 relating to conversion of nonparticipating royalty interests from real estate to personal property for banking law purposes, were designed to help banks deal with the persistent problem of unmarketable OREO, not to encourage banks to get into the oil and gas business, even though a bank now has an avenue for retaining an income-producing property. Just don't let the tail wag the dog!

For more information, please contact Everette Jobe at 512-475-1321 or ejobe@dob.texas.gov.

BSA E-Filing

Barbara Winters

Beginning on July 1, 2012, the Financial Crimes Enforcement Network (FinCEN) required that certain forms, primarily Currency Transaction Reports (CTRs) and Suspicious Activity Reports (SARs), be filed electronically. As part of the E-Filing initiative, FinCEN developed new CTR and SAR reports but allowed banks to continue to file the "legacy" forms for CTRs and SARs electronically

Despite the E-Filing mandate, a few banks continue to file "legacy" reports in paper format. When this occurs, FinCEN sends the bank a letter requesting that the BSA E-Filing system be used. The institution is given 30 days to use the E-Filing system before a follow up letter is sent. The Department of Banking is notified each time a bank receives a letter from FinCEN and then contacts the bank to determine why the report was not filed electronically.

As of March 31, 2013, banks will not be allowed to submit "legacy" reports in a paper format or upload "legacy" reports to the BSA E-Filing system. Use of the new CTR and SAR format will be mandatory. Also as of March 31, 2013, the time-frame for filing CTRs electronically will be 15 days instead of the current 25 days.

FinCEN may impose civil money penalties for noncompliance with their regulations, including $500 for each negligent currency transaction or suspicious activity reporting violation under 31 C.F.R. § 1010.820.

If your institution needs help with E-Filing, contact FinCEN's Regulatory Helpline at 1-800-949-2732. For technical assistance with the BSA E-Filing System, call the BSA E-Filing Help Desk at 1-866-346-9478.

DOB Internship Program

Kurt Purdom

The Texas Department of Banking has initiated an intern program called the Student Educational Employment Program (SEEP). The SEEP is a partnership between the Department and Texas universities that have programs geared towards a banking curriculum or banking careers. At present, both Sam Houston State University and Texas A&M University have banking curriculum programs.

The SEEP is designed to match our agency with students who have an aptitude for examination/auditing and have an interest in pursuing financial supervision and regulation as a career. Through these partnerships, the agency hopes to increase new-hire job satisfaction and employee retention.

The SEEP provides a cooperative educational experience by allowing students the opportunity to earn money and continue their education, while obtaining on-the–job financial examiner experience with the Department. The SEEP gives the agency an opportunity to build a relationship with this student. The ultimate goal is to offer the student regular full-time employment, upon graduation, if the student excels in the program, meets the requirements of an entry-level financial examiner and has a continued interest in a career as a financial regulator and the agency has a staffing need.

The Department plans to offer internships to four qualified applicants in 2013, either during the spring semester or summer break. The internships last for nine to twelve weeks, and the interns will be assigned to one of our four regional offices, depending upon the availability of training resources.

If you have any questions about this program, contact Kurt Purdom, Director of Bank and Trust Supervision at 512-475-1333.

Leilani Lim-Villegas

In an effort to motivate bankers to become more involved in financial education, the Texas Finance Commission adopted a rule in 2008 to encourage state-chartered banks to initiate in-school banking programs, where fees are waived and locations are not deemed a branch. A good example leading this initiative is offered by Happy State Bank in Amarillo, Texas. The Texas Department of Banking is pleased to highlight their financial literacy efforts.

Parents prepare their children for the many challenges they will be confronted with throughout their lives. One challenge all children will face is how to effectively manage their finances. Happy State Bank is committed to preparing children for this challenge through their *Kids'* Bank program. The *Kids'* Bank program was developed to teach children the value of saving money and introducing them to the many aspects of banking first-hand at an in-school bank. Each in-school bank is supervised by two Happy State Bank employees, and is operated by students that have completed an application and interviewed at the bank. The positions the children apply for include: teller, branch manager and marketing associate.

The *Kids'* Bank program supports Happy State Bank's efforts in the area of "social skills" as students learn the responsibilities of their "job" in addition to "customer service" behavior. In the bank's efforts to encourage families to begin saving for their children's future, a savings account without service fees or a minimum deposit requirement is offered to students. Each child receives a savings book in which they can track their deposits and withdrawals. The benefit of saving early in life helps children achieve financial success as adults. The *Kids'* Bank Savings Account empowers children with the knowledge, experience and tools to start life on a good financial path.

In 2012, Happy State Bank supported 16 *Kids'* Bank schools in ten school systems throughout the Texas Panhandle, and established over 1,200 *Kids'* Bank accounts. This year, Happy State Bank is proud to announce the expansion of their *Kids'* Bank program into 15 additional Amarillo schools in conjunction with the Smarter Texans Save study. Through this study, Amarillo students have a unique opportunity to participate in important research that could break new ground

in financial capability for not only other Texas school districts, but for schools across the nation. Amarillo is the second community to be selected to participate in this study, which will serve as a national model for school-based financial education. The lessons focus on personal financial topics such as saving, banking, and money management. The goal is to help students learn important financial skills, including saving money and spending wisely.

In addition to the *Kids'* Bank program, Happy State Bank is also a Partner-in-Education with the Amarillo Independent School District and is an active supporter of Junior Achievement for the High Plains. Partners-in-Education is a non-profit organization with a mission to strengthen and enhance public education in public schools through business and community partnerships. By leveraging community resources and volunteers, Partners-in-Education provides programs that support students in the public school system. Junior Achievement is also a non-profit organization that is dedicated to educating students about workforce readiness, entrepreneurship and financial literacy through experiential, hands-on programs. These programs help prepare young people for the real world by showing them how to generate wealth and effectively manage it, how to create jobs which make their communities more robust, and how to apply entrepreneurial thinking in the workplace.

Happy State Bank's involvement with these two organizations helps their staff to gain a better sense of their communities, as well as increase awareness of the challenges facing public schools. Through these organizations, the bank has the opportunity to provide students with the skills and knowledge to be more prepared for financial challenges they face as adults.

In addition to Partners in Education and Junior Achievement, Happy State Bank employees also have the opportunity to volunteer on the bank's teaching team. This team responds to request from the community with regard to financial education. One of the financial education curricula taught by the team is the FDIC "Money Smart for Young Adults." This curriculum helps youth ages 12-20 learn the basics of handling their money and finances, including how to create positive relationships with financial institutions.

Congratulations to Happy State Bank for a job well done and we wish them continued success!

Future Complaint Sharing with the CFPB

Wendy Rodriguez

In December 2012, the Consumer Financial Protection Bureau (CFPB) announced its plans to share complaint data they receive with state regulatory agencies. The Texas Department of Banking has been working in conjunction with the Conference of State Bank Supervisors and the CFPB to finalize a national agreement that will permit the sharing of these complaints with the states.

Once the agreement is finalized and signed, the sharing of consumer complaints will take place via a secure portal that protects the confidentiality of personally identifiable information. The Department will be one of several states testing the portal before it is released to other state banking departments.

CFPB also plans to accept complaints from the agencies and will make the data available to other federal agencies, state attorneys general, local agencies, congressional offices as appropriate, and other governmental organizations.

Currently, the CFPB accepts complaints on credit cards, mortgages, student loans, checking accounts, savings accounts, credit reporting, bank services, and other consumer loans.

TABLE I
Quarterly Balance Sheet and Operating Performance Ratios
for Texas State-Chartered Banks 9/30/12 Through 9/30/11

ACCOUNT DESCRIPTIONS (IN MILLIONS OF $)	9/30/12	6/30/12	3/31/12	12/31/11	9/30/11
Number of State-Chartered Banks	296	300	301	302	305
Total Assets of State-Chartered Banks	198,470	196,322	175,482	170,401	168,477
Number of Out-of-State, State-Chartered Banks Operating in Texas	27	26	25	25	25
Total Texas Assets of Out-of-State, State-Chartered Banks Operating in Texas	38,370	36,061	35,985	35,985	35,985
Subtotal	236,840	232,383	211,467	206,386	204,462
Less: Out-of-State Branch Assets/Deposits	-42,210	-37,987	-37,987	-37,987	-37,987
**Total State Banks Operating in Texas	194,630	194,396	173,480	168,399	166,475
BALANCE SHEET (Tx. State-Chartered Banks)					
Interest-Bearing Balances	13,319	12,942	12,083	10,307	12,557
Federal Funds Sold	1,172	1,229	1,523	1,492	1,601
Trading Accounts	651	707	575	1,176	554
Securities Held-To-Maturity	9,943	9,531	9,868	8,853	8,255
Securities Available-for-Sale	45,210	44,798	35,918	34,512	33,480
Total Securities	55,804	55,036	46,361	44,541	42,289
Total Loans	111,010	111,193	100,387	99,779	97,459
Total Earning Assets	181,305	180,400	160,354	156,119	153,906
Premises and Fixed Assets	3,234	3,274	2,945	2,901	2,895
Total Assets	198,470	196,322	175,481	170,390	168,477
Demand Deposits	20,589	20,255	18,617	18,067	17,399
MMDAs	83,285	81,164	67,197	64,009	60,956
Other Savings Deposits	13,027	12,762	12,193	11,576	12,417
Total Time Deposits	36,168	37,390	36,813	36,741	37,383
Brokered Deposits	1,673	1,526	1,681	1,865	2,188
Total Deposits	161,153	159,793	143,014	138,509	136,248
Federal Funds Purchased	3,489	3,841	3,002	2,882	3,037
Other Borrowed Funds	5,785	5,535	5,405	5,355	5,395
Total Liabilities	175,802	174,043	155,875	151,194	149,116
Total Equity Capital	22,664	22,279	19,606	19,196	19,360
Loan Valuation Reserves	1,664	1,725	1,637	1,650	1,670
Total Primary Capital	24,328	24,004	21,243	20,846	21,030
Past Due Loans > 90 Days	464	436	499	512	579
Total Nonaccrual Loans	1,661	1,731	1,848	1,826	1,840
Total Other Real Estate	756	827	855	860	926
Total Charge-Offs	387	265	122	788	582
Total Recoveries	108	72	31	155	114
Net Charge-Offs	279	193	91	633	468
INCOME STATEMENT					
Total Interest Income	4,982	3,401	1,548	6,148	4,599
Total Interest Expense	544	384	193	892	691
Net Interest Income	4,438	3,017	1,355	5,256	3,908
Total Noninterest Income	2,080	1,370	598	2,204	1,619
Loan Provisions	193	124	74	460	315
Salary and Employee Benefits	2,423	1,632	727	2,723	2,002
Premises and Fixed Assets Expenses (Net)	546	378	168	681	502
All Other Noninterest Expenses	1,413	950	423	1,637	1,221
Total Overhead Expenses	4,382	2,960	1,318	5,041	3,725
Securities Gains (Losses)	103	101	32	75	67
Net Extraordinary Items	-2	0	0	4	4
Net Income	1,561	1,068	454	1,562	1,202
Cash Dividends	1,022	557	173	767	494
RATIO ANALYSIS					
Loan/Deposit	68.88%	69.59%	70.19%	72.04%	71.53%
Securities/Total Assets	28.12%	28.03%	26.42%	26.14%	25.10%
Total Loans/Total Assets	55.93%	56.64%	57.21%	58.56%	57.85%
Loan Provisions/Total Loans	0.23%	0.22%	0.29%	0.46%	0.43%
LVR/Total Loans	1.50%	1.55%	1.63%	1.65%	1.71%
Net Charge-Offs/Total Loans	0.25%	0.17%	0.09%	0.63%	0.48%
Nonperforming+ORE/Total Assets	1.45%	1.53%	1.82%	1.88%	1.99%
Nonperforming+ORE/Primary Capital	11.84%	12.47%	15.07%	15.34%	15.91%
Net Interest Margin	3.26%	3.34%	3.38%	3.37%	3.38%
Gross Yield	4.73%	4.86%	4.89%	4.90%	4.91%
Return on Assets	1.05%	1.09%	1.03%	0.92%	0.95%
Return on Equity	9.16%	9.59%	9.26%	8.14%	8.26%
Overhead Exp/TA	2.94%	3.02%	3.00%	2.96%	2.94%
Equity/Total Assets	11.42%	11.35%	11.17%	11.27%	11.49%
Primary Capital/Total Assets+LVR	12.16%	12.12%	11.99%	12.12%	12.36%

*Unrealized gains/losses are already included in equity capital figures.
**Total State Banks Operating in Texas includes branches of out-of-state, state-chartered banks.
Data was derived from the FDIC website.

TABLE II

Comparative Statement of Condition

Commerical Banks Domiciled in Texas

September 30, 2012 and September 30, 2011

ACCOUNT DESCRIPTIONS (In Millions of $)	9/30/2012 STATE CHARTERED		9/30/2012 NATIONAL CHARTERED		9/30/2012 ALL BANKS		9/30/2011 ALL BANKS	
Number of banks	296	% TA	241	% TA	537	% TA	554	% TA
BALANCE SHEET								
Interest-Bearing Balances	13,319	6.7%	9,276	6.3%	22,595	6.5%	25,278	8.0%
Federal Funds Sold	1,172	0.6%	10,677	7.2%	11,849	3.4%	5,002	1.6%
Trading Accounts	651	0.3%	45	0.0%	696	0.2%	722	0.2%
Securities Held-To-Maturity	9,943	5.0%	2,580	1.7%	12,523	3.6%	10,492	3.3%
Securities Available-For-Sale	45,210	22.8%	21,520	14.6%	66,730	19.3%	58,485	18.5%
Total Securities	55,804	28.1%	24,145	16.4%	79,949	23.1%	69,699	22.0%
Total Loans	111,010	55.9%	95,144	64.5%	206,154	59.6%	192,494	60.8%
Total Earning Assets	181,305	91.4%	139,242	94.4%	320,547	92.6%	292,473	92.3%
Premises & Equipment	3,234	1.6%	1,977	1.3%	5,211	1.5%	5,138	1.6%
TOTAL ASSETS	198,470	100.0%	147,514	100.0%	345,984	100.0%	316,758	100.0%
Demand Deposits	20,304	10.2%	13,267	9.0%	33,571	9.7%	31,012	9.8%
MMDAs	83,285	42.0%	45,591	30.9%	128,876	37.2%	112,919	35.6%
Other Savings Deposits	13,027	6.6%	36,053	24.4%	49,080	14.2%	37,658	11.9%
Total Time Deposits	36,168	18.2%	23,000	15.6%	59,168	17.1%	63,349	20.0%
Brokered Deposits	1,673	0.8%	2,413	1.6%	4,086	1.2%	4,649	1.5%
Total Deposits	161,153	81.2%	123,773	83.9%	284,926	82.4%	259,162	81.8%
Fed Funds Purchased	3,489	1.8%	1,643	1.1%	5,132	1.5%	5,419	1.7%
Other Borrowed Funds	5,785	2.9%	5,443	3.7%	11,228	3.2%	9,675	3.1%
TOTAL LIABILITIES	175,802	88.6%	131,800	89.3%	307,602	88.9%	280,167	88.4%
Equity Capital	22,664	11.4%	15,703	10.6%	38,367	11.1%	36,590	11.6%
Allowance for Loan/Lease Losses	1,664	0.8%	1,767	1.2%	3,431	1.0%	3,789	1.2%
Total Primary Capital	24,328	12.3%	17,470	11.8%	41,798	12.1%	40,379	12.7%
Past due >90 Days	464		398		862		877	
Nonaccrual	1,661		1,711		3,372		4,091	
Total Other Real Estate	756		683		1,439		1,689	
Total Charge-Offs	387		413		800		1,327	
Total Recoveries	108		65		173		270	
INCOME STATEMENT	Y-T-D		Y-T-D		Y-T-D		Y-T-D	
Total Interest Income	4,982	100.0%	4,049	100.0%	9,031	100.0%	9,101	100.0%
Total Interest Expense	544	10.9%	366	9.0%	910	10.1%	1,179	13.0%
Net Interest Income	4,438	89.1%	3,683	91.0%	8,121	89.9%	7,922	87.0%
Total Noninterest Income	2,080	41.8%	1,090	26.9%	3,170	35.1%	2,809	30.9%
Loan Provisions	193	3.9%	257	6.3%	450	5.0%	771	8.5%
Salary & Employee Benefits	2,423	48.6%	1,384	34.2%	3,807	42.2%	3,502	38.5%
Premises & Fixed Assets (Net)	546	11.0%	354	8.7%	900	10.0%	901	9.9%
All Other Noninterest Expenses	1,413	28.4%	970	24.0%	2,383	26.4%	2,271	25.0%
Total Overhead Expenses	4,382	88.0%	2,708	66.9%	7,090	78.5%	6,674	73.3%
Securities Gains(losses)	103	2.1%	43	1.1%	146	1.6%	98	1.1%
Net Extraordinary Items	(2)	0.0%	0	0.0%	(2)	0.0%	4	0.0%
NET INCOME	1,561	31.3%	1,374	33.9%	2,935	32.5%	2,560	28.1%
Cash Dividends	1,022		796		1,818		1,502	
Average ROA	1.05%		1.24%		1.13%		1.07%	
Average ROE	9.16%		11.64%		10.17%		9.31%	
Average TA ($ Millions)	671		612		644		572	
Average Leverage	11.42%		10.65%		11.09%		11.55%	
Dividends/Net Income	65.47%		57.93%		61.94%		58.67%	

*Unrealized gains/losses are already included in equity capital figures.

TABLE INCLUDES ONLY BANKS DOMICILED IN TEXAS. BRANCHES OF OUT-OF-STATE BANKS ARE NOT INCLUDED.

Data was derived from the FDIC website.

Financial data does not include one state-chartered bank that has fiduciary activities only and does not have the power to accept or pay deposits.